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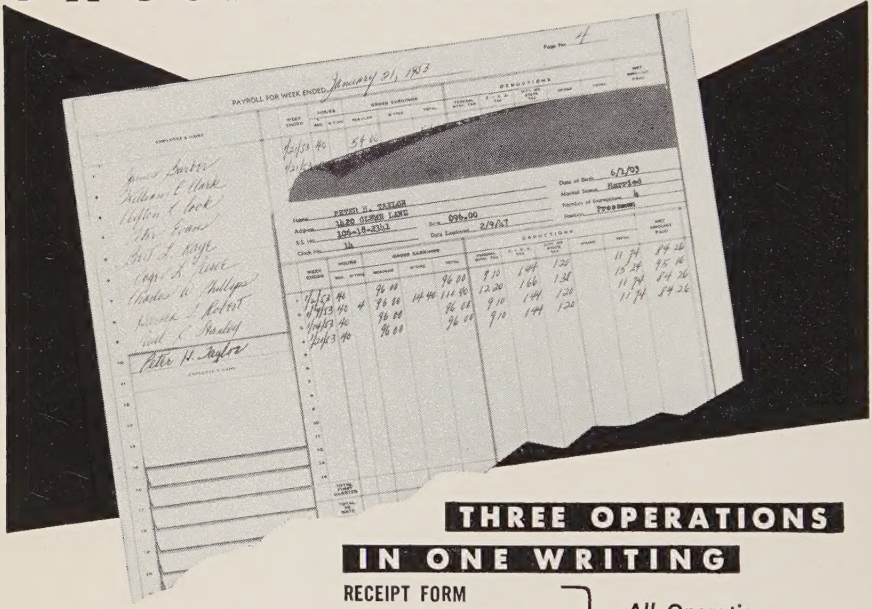
the Illinois Certified Public Accountant

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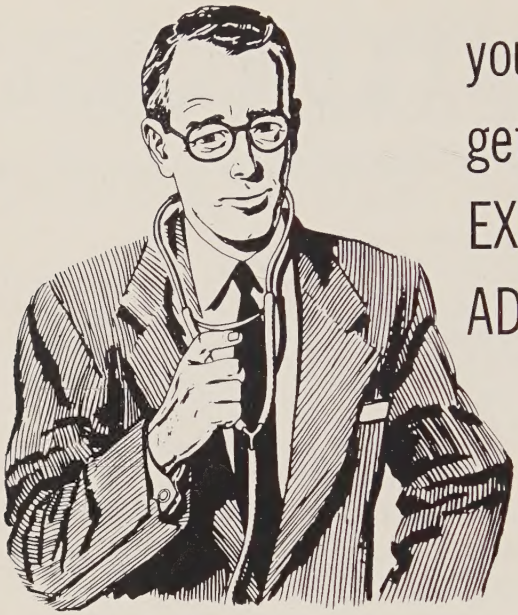
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THE ILLINOIS Certified Public Accountant

THE ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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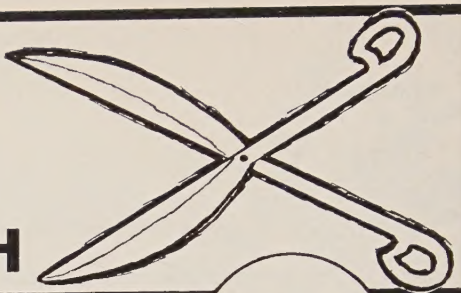
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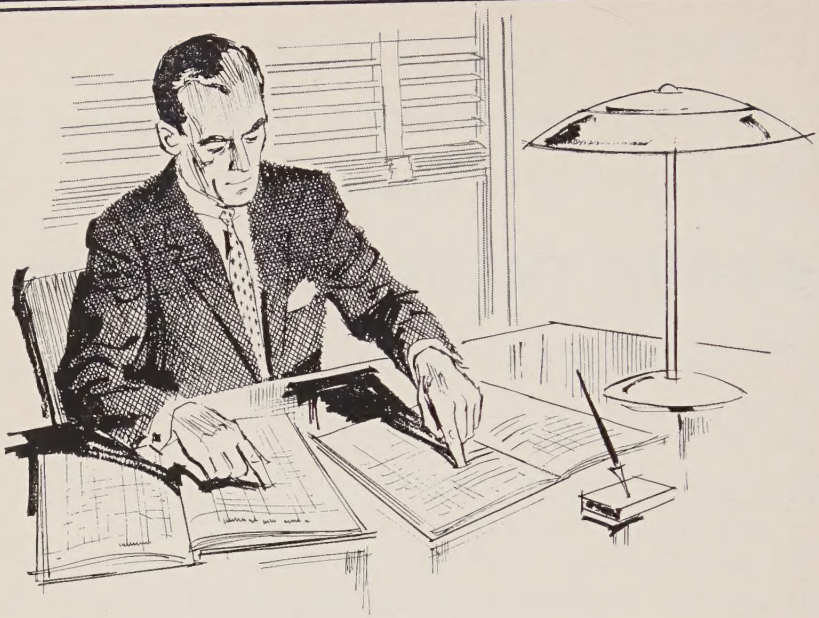
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PRESIDENT'S PAGE



One of the pleasant privileges which goes with the presidency of the Illinois Society is this opportunity to have my own page in this quarterly publication. Here, and three more times during my term, without censorship (and possibly without readership, either) I can freely exercise one of the perquisites of the office . . . thus far, the only free thing that I have found connected with the job.

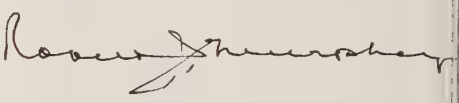
It would certainly be a rich experience if a Society president could meet and know every member personally, and have the chance to 'talk shop' with each one about the profession generally and particularly about this Society of ours. To the limited extent that it has been my good fortune to do this with a fractional cross section of our membership, I have been impressed and distressed with two conflicting points of view. The first is objective, producing a lot of good ideas and constructive suggestions for the improvement of our common cause; the other is purely subjective and its proponents think of the Society as being divided into various groups or classes, each with special aims and interests, competing with every other for a larger share of the Society's service and attention. Those who hold the latter view are generally unhappy with the Society, and if they take any interest at all in its activities such interest is militant in behalf of the particular segment of membership in which those members classify themselves.

The Creator made man in His own image, but wisely there have never been two exactly alike. The differences among us provide the individuality which makes life interesting. In our nation there are differences of sex, race, creed, nationality, political affiliation, etc., but we are all Americans. In our Society, the 2600 members have the additional differences of professional interest, activity, size, location, etc., but we are all Certified Public Accountants. This is the common denominator prerequisite to membership in our professional organization.

The corporate objects of the Illinois Society as specified in its charter granted 54 years ago refer only to Certified Public Accountants. Our first obligation is to serve the best interests of all of our members as Certified Public Accountants, regardless of their specific interest, activity, size, location, or any other secondary considerations.

There is no factual basis for the occasional criticism that our Society is 'run' by, and for the benefit of, its members in public practice, or in the large firms, or in Chicago; a casual inspection of the list of 'Officers and Committees' recently distributed should dispel any fears that the Society is not working for the best interests of all Certified Public Accountants in Illinois. I hope you will agree that such efforts deserve the active support and interest of every member.

Cordially yours,



INVENTORIES—A CHALLENGE TO THE AUDITOR

W. W. Jones

I believe that if I wanted to select, for a Gallup poll to be taken among any group of accountants and auditors, the question that would bring the closest thing to unanimity in the answer elicited, that question would be—What single area of accounting or what item in financial statements is most likely to give the greatest trouble, and provide the severest test, for the accountant or the independent auditor? I am quite sure that the answer would be—*Inventories.*

If you will, visualize with me the balance sheet of a typical moderate-sized manufacturing company. Most of the assets and liabilities are such that they lend themselves to definite determination. That is, the proper carrying amount for such items as cash, receivables, property accounts, liabilities, etc., can usually be audited to reasonable satisfaction as to amount. True, much judgment comes into play in such areas as—the need for reserves for receivables, distinction between "capital" and "expense" items in fixed assets, etc. However, the unknown or the fuzzy areas are less apt to be encountered in such places than is the case with inventories.

To illustrate, I should like to pose a few questions or problems as a prelude to some lively discussion that I am sure will be generated in the period that follows. To the auditor, inventory presents two distinct problems that must be met:

1. Satisfaction as to quantities.
2. Valuation of those quantities.

Satisfaction as to Quantities

At the 1939 annual meeting of the American Institute, approval was given to the "extension of auditing procedures," one of which was the requirement for the observation of inventories. Failure to apply such a procedure, where *practicable and reasonable,* in general, precludes the expression of an opinion on the fairness of the financial statements taken as a whole. The procedure, that is observation of the inventory, must be *both* practicable and reasonable. In *auditing,* practicable means "capable of being done with available means—or—with reason or prudence"—*reasonable* means "sensible in the light of the surrounding circumstances."

Because of the growing size and complexity of business operations, accounting procedures (and the auditing function that follows) have been put to severe strain to meet the

W. W. JONES is resident partner in the firm of Ernst and Ernst, Philadelphia. This article is adapted from a paper presented at the Third Annual Accounting Study Conference which was held at the Pennsylvania State University in August, 1957.

test of practicability and reasonableness—for instance, the desirability of devising accounting records and procedures that make it unnecessary to have costly year-end plant shut-downs for physical inventory purposes. This means that rotating or cycle counting can be used by the company to adjust records. What is the independent auditor to do in such a situation in order to satisfy himself as to the general accuracy of the records of physical quantities? Obviously, the crux of such a situation as this is—what is the company's internal control set-up? That is, assuming that the actual physical counting—done on a continuous, routine basis—can be tested through periodic observation by the auditor, how about the "paper work" cut-off and the accounting for transactions intervening between the physical count dates and the year-end?

The situation facing the auditor is the same with those companies that take an annual physical inventory once a year, but at a date other than the fiscal year-end. There are many good reasons for doing this and, in some respects, it is of great help to the auditor. I know that if all December 31st companies were to shut down and take inventory over the New Year's holiday, we auditors would be completely crushed under an avalanche of physical inventory work. For the company, a physical inventory other than at its year-end may have several advantages. A date coincident with the annual vacation plant shut-down is usually beneficial and less disruptive to production schedules; an early physical inventory gives the company a head start on the job of computing the inventory pricing, extensions, footings, etc. For these and other reasons, the auditor may find it appropriate and virtually mandatory to urge his client to schedule physical inventories at a date, or over a period, removed from the end of the fiscal year.

However, this will bring into sharp focus the problem of accounting for inventory transactions between physical counts and the year-end. If the company has the accounting know-how to cost-out sales (and no business enterprise of any size should be without this basic tool), it can handle the problem. But the auditor's job will be greater because he will have to test the record of those transactions to satisfy himself that the physical inventory he observed has been properly "carried forward," so to speak, to the year-end figures to which his opinion is to relate.

In a completely selfish vein, the auditor would, in most cases, have to confess that he would prefer that all inventories be taken at the fiscal year-end with a complete plant shut-down and ample time provided to do the job. When I say this is what we would prefer, I am thinking, not of the burden of accomplishing our work that relates to physical inventories, but rather to that so-called "ideal" arrangement that would provide the greatest assurance of accuracy in the year-end figures. However today's business activities and pressures do not generally give way to the convenience of the auditor and the easing of his task. In many companies there is much reluctance to cease operations to accommodate physical inventory procedures or to schedule such inventory taking on week-ends or holidays when overtime or double-time pay premiums would result. Consequently, the accounting departments of modern business must devise ways to accomplish the

equired inventory accountability ests and checks with minimum irri- ation and disruption to the business f production and sales. The inde- endent auditor must be ingenious nd resourceful enough to obtain his atisfaction, in compliance with re- uired standards of audit, without eing unreasonable or extravagant n the expenditure of time and effort.

In addition to presenting a chal- enge to the auditor as to the timing f inventory observations and tests, any physical inventory situations rovide some unusual and difficult roblems by reason of the nature of he business operation and the char- cteristics of the inventories. As I ave already mentioned, in the rowing complexity of today's busi- ess operations are more apt to be pread around the country in numer- us locations. New manufacturing nd/or distribution processes tend o complicate the inventory handling nd storing problems which result n it being more difficult for the usiness to physically check its in- entories and, of course, this means ifficulties for the auditor.

I am sure that all of you encounter ituations where it is difficult to satis- actorily check inventory quantities. t may be because of the inherent ature of the operation, such as a ompany that owns and operates ending machines which are scattered bout in thousands of locations over wide area. Or it may be because f an unusual and unexpected cir- umstance that has developed at the me of physical inventory taking, uch as a strike, adverse weather con- itions, etc. As I stated earlier, the xtended audit procedure of inven- ory observation must be both prac- cable and reasonable; however, it also stated that "it is believed that there are very few cases in which the additional procedures cannot be applied to inventories."

In the 1956 edition of Accounting Trends and Techniques, one analysis given relates to cases involving the omission of auditing procedures. Of the 600 annual reports covered in the edition, 58 revealed the omission of certain normal auditing procedures. However, only six of these omissions related to inventories and of the six, one omission arose because of conditions which made physical inventory tests impracticable, three were omissions as to the beginning inventory because the audit represented a first examination, one was because the company changed its fiscal year and did not take an inventory, and the sixth case was one in which the company, because of the need to meet sales demands, did not shut down production to take an inventory of work-in-process. It is interesting to note that, of these six cases of omission of physical inventory procedures, the auditors' reports in four cases stated that they had satisfied themselves by other procedures and, only in the first case, was there a qualification taken in the opinion paragraph. I realize it is dangerous to draw any strong conclusions from this particular survey report, but it does suggest that there are not many times when the extended auditing procedures relating to physical inventories cannot be and are not carried out.

Of course, I well know that most of us have clients reluctant to authorize us to carry out these procedures but I am equally sure that in most of those cases where we do not observe or test check physical inventories and we try to satisfy ourselves by other means so we will not have to

qualify our opinion, we find ourselves spending more time (and more of the client's money) than had we been permitted to observe or test physical inventories in the first place.

I have mentioned the challenge that the auditor faces in attaining satisfaction as to physical quantities. This challenge touches upon the means of going about achieving this satisfaction and the extent to which tests should be made. It is one aspect of the auditor's work that lends itself to the technique of sampling. I have run into a good many unique physical inventory problems over the years, some of which I never found the complete answer to. I can remember one situation that involved a "sampling" approach and that almost resulted in the early end to a public accounting career. It was a brewery and, in my best expression of haughty suspicion that identifies the "eager beaver" junior, I ordered the brewmaster to tap the huge vats to make sure it was beer and not water. Well, he did and it was beer, as I found out as I wiped it off my feet. After that, I reasoned that "practicable and reasonable" permitted reliance upon the vat's gauge. In a somewhat later year, I discovered that a course in algebra, and even solid geometry, had not taught me how to determine the cubic content of huge piles of sand and crushed stone, especially if those piles had gradually sunk below the surrounding ground level and broken through the base of my theoretical cone. With that, I went to the company's engineer who gave me a quick, practicable lesson in "rule of thumb" estimating.

In all inventory auditing procedures, some study and review of book records is necessary and if it had been done, as it should have been in both of the cases I have cited, much would have been accomplished toward easing the auditor's mind. Where inventories are of such shape, size and location that counting is reasonably easy, such can be done in great or small doses. Personally, I have always felt that, in most instances the auditor's time can be best invested in observation. Watching others do the job can reveal a lot to the auditor. It is a well known and accepted maxim that the responsibility for the determination of physical inventories—that is, the planning and taking of the physical counts, the setting of unit prices or other measures of valuation, and the mathematical computations, are the responsibility solely of the company being audited. The auditor should be interested in just how the company goes about meeting this responsibility and, as far as determination of physical quantities is concerned, this interest on the part of the auditor should be "before the act." That is, the auditor should acquaint himself with the company's plans for the taking of physical inventories or its scheme for testing book records where "once a year" physical counts are not made. If the company depends on an annual physical inventory rather than a routine of checking book records, the auditor's task is more concentrated insofar as time is concerned. In such a case, it is most important that the auditor have the opportunity to review the details of the company's planning for the inventory so that he can judge for himself whether or not such procedures should produce a reliable result.

Many companies have a system of inventory accounts that provides con

inuous figures as to physical quantities and, possibly, values as well. In uch situations, there may be widely ifferent procedures followed by hese companies in testing such recrds. Some may feel that tests can e quite limited, others may carry ut their testing more extensively so s to cover all items at least once a ear. Of course, the extent to which ne company should carry out physal tests (and also the extent of the uditor's own tests) will be, or should e, determined by the reliability of ne records as evidenced by the reults of comparing quantities on hand ith book record balances. The auitor is also faced with following one r both of two courses of action in btaining his own satisfaction as to uantities. He can be present at imes when the company employees re physically verifying the accuracy f the book records or he can direct is efforts to making his own test ounts or he can use both methods. Whatever may be his general proram, the auditor must choose wisely o as to obtain the broadest coverage ossible within the limits of reasonble time and effort.

The challenge of inventories to the uditor, insofar as satisfaction as to hysical quantities is concerned, is ne that requires imagination and ngenuity in planning and performnce so as to minimize interference ith production activity, to minimize uditors' time and effort, and to naximize satisfaction as to the exstence and condition of the invenories. The challenge also extends to ne task of convincing the client that ood physical control and accountaility records are a must for any uccessful business operation. In act, I am not so sure but that this is the first challenge that the auditor should meet and master.

Thus far, my remarks have been limited to the problem of audit satisfaction as inventory quantity and condition. Much more could be said, or questions raised in this area. For instance, the subject of how to satisfactorily test or check physically work-in-process inventory could be batted back and forth quite awhile. I believe that it is fair to say that, in most cases, the inventory of work-in-process is in such condition and location that it is virtually impossible to "inventory" it in the sense of counting or weighing or otherwise measuring physical quantities. In the case of a large and intricate product, the finished or partially completed parts or components may be scattered all over the plant. Where sub-assemblies are involved, the work-in-process may include items that, to the non-technical auditor, may look like finished products or even like purchased items as to which no labor has been applied.

All of this is said to lead up to what I believe is the inescapable conclusion as to auditing procedures for work-in-process inventories. That is, that the auditor will, in most instances, have to place a greater degree of reliance on book records—and depend less on physical counts—for work-in-process than for any of the other classes of inventory. By book records I do not necessarily mean detailed accounting records but rather production records which must provide the guide as to where the inventory is at a given time and what is its stage of completion. It is in this area of work-in-process that the auditor can do some "looking around" the plant, satisfying himself as to the physical existence of

certain orders, even if the items he looks at can't be counted, weighed or otherwise broken down into the raw material ingredients. The auditor can and should also give a good deal of attention to the accounting records and entries that pertain to the charging in of material, labor, and overhead, and the costing out of shipments to make sure there are no material gaps or unreconcilable swings up or down as to the residue balance for work in process.

Valuation of Inventory Quantities

Chapter 4 of the *Restatement and Revision of Accounting Research Bulletins* deals with the accounting principles that relate to inventory pricing. I have no intention of dwelling at length on the contents of that chapter because I am sure that all here are generally familiar with it. There are a few basic truths, so to speak, that merit repeating here:

1. A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

2. The primary basis of accounting for inventories is cost.

3. A departure from the cost basis of pricing inventory is required when the utility value of the goods is no longer as great as its cost.

I set forth the first one as I did because I believe it deserves first place in line. That is, I think we should, in our struggles with inventory valuation problems, keep more clearly in mind that the inventory valuation determination exerts its greatest effect upon the profit and loss or operating statement. I an cal) case—suppose that you coul satisfy yourself as to all accountin aspects of the stated amounts fo sure that many of us, including my self, are often guilty of thinkin principally of the balance sheet a we set about to challenge the inven tory figures. We are so afraid tha the balance sheet figure may not b what is right as a matter of value— as a balance sheet item—that we d not keep asking ourselves whether o n o t the inventory "carry-over" amount is a proper charge agains sales or revenues of the comin months or year.

The second so-called basic trut is that "cost" is the primary basi of accounting for inventories, Ah— that is wonderful—just one littl four letter word is all we have t keep our eyes on. The pronounce ment in Chapter 4 even goes o beyond that and professes to help u out some more by suggesting severa kinds of cost that are acceptable However, it stops far short of tellin us specifically and concisely just ho a particular variety of cost shoul be computed. And I think it is we that it does not go any further tha it does. First of all, I don't believ such an interpretation or formula c cost could be presented in any wri ing of absorbable length and, second ly and more importantly, if it coul and did it would take all of the fu and attraction out of this most cha lenging area of the auditor's wor

How many of you have been calle upon to make an audit of a busines in connection with the sale or pu chase of that business with you findings being instrumental in th determination of the price to be r ceived or paid? Let me go furthe in this hypothetical (but very typ

sets and liabilities, except that the ventory valuation was giving ouble. The company had a stand- d cost system, which standards had t been adjusted for the past three ars, because in that period the tual costs had not risen significant- beyond the standards. In the year der review, the "creeping up" ovement of actual cost experience d reached a point where, on the erage, actual costs were approxi- ately 15% above standard com- red with about 10% at the end the previous year. So, the com- ny (which is the seller in this stance) concludes that good ac- unting practice calls for a revision standards upward to the current % higher level. You are charged th the responsibility of auditing e financial statements and your ent is the buyer. What is there at says 15% deviation from actual sufficient to require adjustment of ndard but 10% is not enough? here does the admonition that the counting principles shall be ap- ed on a consistent basis come in? I dare say that most if not all us could very easily satisfy our nscience of independence and ob- tivity if that same company had ncluded that a possibly temporary viation of 15% did not require, even excuse, a change in standards. ese particular percentages that I ppened to choose are not meant have any special significance but her are to illustrate that there is pat answer to the question of what e valuation of inventory should present. We would all agree that should not exceed market, either placement or disposal market. That t comment may not be wholly nsistent with the rather involved definition of "market" set forth in Chapter 4. One theory or understanding of inventory value applicable to a "going concern operation which may not be fully orthodox or normal would hold that no profit is realized from the sale of products or merchandise unless the proceeds from sale are sufficient to (1) pay an appropriate and proportionate share of current expenses being sustained in the selling and administrative function; (2) replace the products or merchandise at current costs, with the excess representing the profit that has been realized. This may not be so much different from the meaning behind the definition of "market" contained in Chapter 4, but it serves to re-emphasize what was said earlier—that the most important aspect of inventory valuation is its impact on the operations and the operating statement of fiscal periods to come.

I said a moment ago that we all would agree that inventory should not be valued in excess of market. This is a handy rule of thumb to have but it is applicable in only a minority of situations. In most cases, we must start out with the reminder that inventory should be stated at "cost." As I have said, "cost" is many things. There are a number of generally understood and accepted varieties of cost that find favor—and application—in different situations: first-in, first-out, last-in, first-out, average cost, specific lot cost, etc.

It is not too difficult to distinguish between these half-dozen or less general types and to hold to the general type that has been adopted. What tests the objectivity and resourcefulness of the auditor are the many shades of meaning and interpretation

of the several general types. Again I refer to the use of standards, a device that certainly is becoming more and more useful and sensible in the costing and inventory accounting function.

Much is being said in recent years about "direct costing" which reasons that certain expenses and costs, usually or formerly thought of as being associated with a product, should be absorbed as period charges. That may be all right for operations during the fiscal year but does it meet the year-end balance sheet valuation test of recognizing all costs directly or indirectly incurred in bringing an article to its existing condition or location?

If Company A followed the more normal practice of "inventorying" all manufacturing overhead by recognizing such cost elements in the inventory pricing and Company B, producing the same type of products, excluded some portion of the manufacturing expense, would you call one right and the other wrong? Before someone jumps up to answer, I'll give the same answer as I think you would—What is the effect of the exclusion, in the second company, of certain expenses and if such effect is not material, we could not or should not challenge it. Well, that word "materiality" is a very convenient escape-hatch in a lot of situations but I am afraid that it is sometimes "over-done" in that we fail to come to grips with a problem, or a beginning of a problem, that some day may be of significance.

This whole matter of proper accounting for inventories usually confronts us in relation to a company's representation of its financial condition and in its determination of income tax liabilities. Usually in th first case, the company and we ten to lean to the conservative or saf side and, as for income taxes, th leaning-over may be more pro nounced. However, too often w and our clients fail to give prope recognition to the fact that inventor prices or standards are, or shoul be, guides for business operations the setting of selling prices, budge ing, etc. How about the "doubl standard" of inventory valuation— one for financial statement and in come tax determination purposes an other for setting selling prices? Ca there properly be two values for th same inventory? Should cost stand ards be set at levels which, so fa as can be foreseen, will meet the co and expense experience that wi come in the year ahead? During thes years of almost relentless inflationar trend in costs, to price an inventor at such standards would almost ce tainly result in its being recorde at amounts in excess of actual cost This suggests a double standard an many believe that there is a lot o merit to it.

I have had something to say abou standard costs but have not venture into that bug-a-boo "Lifo." C course, standards may be used fo all the detailed and day-to-day a counting operations with Lifo r served for the once-a-year adjus ment at year-end. Much, almost to much, has been written and spoke about Lifo and I don't propose clutter up the record anymore. Hov ever, its history, its significance, an its place in accounting represent challenge to the auditor— a challeng to know something about it, to be a position to guide a client to, away, from it as the circumstanc

em to dictate. You might conclude at I am lukewarm, even cold, about fo. On the contrary, I believe it s had, and will continue to have, real place in the scheme of things. owever, that is a subject unto itself. Much is said, in discussions and itings about inventory pricing, of e necessity and desirability of con- stency. Obviously, inconsistency isons the value of the comparative rnings figures and, in these days, seems as though the headlines are served for the earnings comparison, .67 a share vs. $2.45 a share. A stortion of such figures through ck of consistency in accounting inciples can wreck havoc in the arket. As a result of this homage id to the "cult of consistency," fear that many an accounting der- ction has remained as such be- use of hesitancy or downright hor- r of "rocking the boat." Consist- cy is a virtue only when the sub- t to which it applies is pure and sullied. Consistency is not an end to itself. This is not to say that at has been or is being practiced necessarily incorrect or unaccept- le. The point I should like to gister is that the desire to achieve nsistency should not lead to aban- ning the natural impulse to keep e accounting as realistic and prop- y attuned as possible.

In the valuation of inventories, re is, in addition to the problem priority, the question of condition, olescence, and other factors affect- the salability of the inventory ms. In this area, much reliance st be placed on the company rec- ds as to usage, sales turnover, etc., well as information that can be ained from responsible officials l other employees who are most familiar with the inventory items. However, while much enlightenment can be obtained in such ways, this is an area where the observing and smart auditor will learn much just by "keeping his eyes open." Obviously, the time that physical inventories are taken, or test counts are being made, provides the auditor with an opportunity to "look around" and possibly detect the presence of overstock, poor quality or downright obsolete and unsalable inventory. In any event, the inventory challenge today is greater than ever in view of the rapidly changing tempo in technical development whereby products and processes are rendered obsolete "over night," so to speak, and inventory values evaporate.

In my remarks I have raised a number of questions and provided few, if any, answers. This is as I intended. I have had the privilege of sitting on the discussion leader side of the table at the several conferences and I know that those speakers that have appeared in the past two years have stimulated some lively and helpful discussions. Harking back to the topic of these remarks of mine—the inventory challenge to the auditor—I should like to summarize briefly:

1. The client is tremendously interested — or had better be — in what his inventory is; and the auditor can be a client's best friend when it comes to guiding him in establishing p r o p e r accounting controls over inventory assets and transactions. And if the client has, or gets, adequate and practicable control over inventory, and keeps it in line through sensible and systematic physical tests, the entire situation will be such that the auditor's job, as an auditor,

will not be difficult. In other words, good inventory accounting will pay big dividends to the business that has it and there will be a by-product in that the auditor will be in a better position to obtain the satisfaction that is needed. Consequently, the challenge to the auditor in this area is to convince your client of the need for proper controls and follow up with guidance and assistance in accomplishing the objective.

2. As to valuation of inventories —for whatever purpose it is to be used—there is much that is written and said as to methods, standards, principles, consistency etc. However, it is a matter that provides an acid test of the auditor's objectivity, independence, and resourcefulness, qualities which every auditor must have but which are difficult to learn anywhere except in the field of experience

ILLINOIS TIGHTENS ITS FISCAL CONTROLS

LLOYD MOREY

In the Winter 1956 issue of *The Illinois CPA* there was a report by Lloyd Morey and Eric L. Kohler of changes in the fiscal organization and procedure in the Illinois state government which they proposed as a result of frauds in the State Auditor's Office. These and other related recomendations were later presented to the Illinois Budgetary Commission [1] and to the Governor, and subsequently to the General Assembly. As a result, numerous actions were taken in the session ending in June, 1957.

This is a review of those laws enacted dealing with fiscal controls. They include a tightening of all the "open ends" which afforded the principal avenues making it possible for former Auditor of Public Accounts Orville E. Hodge to carry out fraudulent operations without ready detection.

Improved Budget Procedure

Budgetary procedures and methods were not sufficiently analytical or intensive to make it possible to determine the validity of requests. These conditions resulted in excessive appropriations to the Auditor and facilitated their improper use.

Senate Bill 624 materially strengthens the Budgetary Commission by adding to its number, and by giving it the necessary professional staff to carry out its functions effectively. It also increases its independence and its responsibility to the General Assembly, broadens its functions and power of review and analysis of budgets and budget requests, and provides an opportunity for it to report independently on the Governor's final budget. The bill also provides needed services to the Appropriation Committees of both branches of the General Assembly.

2. Standards for Procurement and Contracting

The Auditor, in common with other elective offices and many independent agencies, was not subject to laws governing competitive bidding and proper specifications on purchases and contracts. This made it possible to manipulate accounts and issue bonus checks for work not performed, as well as make payments in excess

[1] Report and Recommendations to Illinois Budgetary Commission, by Lloyd Morey, Elbert B. Tanner, Jr., and John S. Rendleman, December 4, 1956.

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of the value of services or materials received.

House Bills 88 and 89 establish the principle of competitive bidding and provide for procurement and contracting practices applicable to all State funds and all State offices and agencies. The bills require the establishment of procedures by each agency to be approved by the Department of Finance. No longer may an elected officer incur obligations without competitive bids and properly drawn contracts.

House Bill 602 sets up a new Division of Administrative Services in the Department of Finance. This Division will be responsible for non-financial functions of that Department, and for administration of House Bills 88 and 89.

A related bill (House Bill 603) transfers the Property Control law administration from the Auditor of Public Accounts to this new Division.

3. Internal Financial Control

The Auditor's Office was the only state office or agency not subject to any outside pre-audit or internal check on its operations. Since it is by Constitution the pre-auditing agency for all state expenditures, and since its operations were not subject to review by the Department of Finance such as required of departments under the Governor, there was no independent review of the expenditures, records, or procedures of this office prior to disbursement of funds.

For the State as a whole there was a lack of proper combination of responsibility and authority to spending agencies for financial management and accountability including adequate pre-audit. There was undue reliance on central pre-audits and accounts which weakened the sens of responsibility on the part o spending agencies. There was n coordinated or comprehensive syste of financial reporting.

House Bill 602 provides for proper distribution of function elimination of existing duplication c records, and extension of financi controls to cover all State agenci instead of being limited as now t the Code Departments. It recogniz the principle of departmental r sponsibility for financial administra tion, and gives the Department Finance a continuous over-view all offices and agencies. It sets u three divisions in the Department Budget, Accounting, and Administra tive Services. The Division of A counting is to prescribe standards financial management and requi regular financial reports. It is carry out spot checks and procedur audits of all departments.

4. Independent Post Audit

The Legislature had provided f a post audit of every other office a agency by the Auditor, but made such provision for the Auditor's ow operations of over seven million d lars for a biennium. Thus the Audit was subject to no independent che on his expenditures, either before after they occurred.

Making the Auditor responsible f post audits in addition to his co stitutional duty of pre-audit al meant an erroneous combination functions in the same office contra to principles of organization and auditing, and to practice in federa state, and municipal governmen generally, and in private business.

Senate Bill 61 creates an Audit General for post audits of all Sta

fficers and agencies. He is appointed y the Governor for a six-year term. [2] Ie is to submit his audit reports to ie Governor, the Budgetary Com- iission, and the Legislative Audit ommission and summary reports to ie General Assembly. Both the overnor and the Legislative Audit ommission may call on him for pecial studies or investigations.

Senate Bill 138 creates the Legis- ative Audit Commission to receive eports of the Auditor General, take eeded action thereon, determine olicies, and provide for an audit of ie Auditor General.

These bills provide a proper sepa- ation of functions which should be dependent of each other, establish uitable professional standards for ie post audit and review activity, nd provide for both recognition of xecutive and legislative responsi- lities while at the same time co- rdinating and serving the needs of oth.

Senate Bill 146, to transfer ad- inistration of Municipal Audit Law rom the elected Auditor of Public ccounts to the Auditor General, assed the Senate but failed passage the House. This program relates rimarily to post audits of munici- alities. While its administration is ot unsatisfactory at present, it is n activity that would be better aced under a non-political officer rofessionally qualified as the Audit eneral must be.

Examination of Financial Institutions

The Auditor was made responsible r sundry laws for the examination of state banks and a wide range of other financial institutions serving the public, approximately 5500 in number. This is a responsibility of major size and public importance. Combining it with the State's own fiscal operations meant placing under one officer two types of activities calling for different professional qualifications and experience. It meant the dilution of the attention required for each of these important operations. It gave the previous Auditor access to certain funds which he was able to manipulate for private ends.

Such a set-up is contrary to the plan of organization in all but five other states. Other than these, a separate officer, in most cases appointed by the governor, supervises examination of financial institutions.

Legislation, headed by House Bill 367, will separate this important function from functions relating to the State operations. It will open the way for selection of a head of this activity on the basis of experience in and knowledge of this field of operation. It will make it possible for such a head to devote his full time exclusively to this one field of activity. Top responsibility for the activity will be centered in the Governor who then will be able to take corrective measures in case of any failure to follow applicable laws or sound principles of management or in the event of any irregularity.

To make this fully effective, the referendum providing change in the Banking Law transferring the examining of State banks from the Auditor of Public Accounts to the Director of Financial Institutions must be approved by a majority of the voters in the November, 1958, election.

[2] He must be a certified public accountant of ostantial auditing experience, licensed as a blic accountant in Illinois. He can be removed y on constitutional grounds of incompetence, glect of duty, or malfeasance in office.

It is of the greatest importance that this change be approved. Otherwise there would be two offices dealing with financial institutions of different kinds, which would be highly undesirable.

All of the foregoing enactments are substantially in accord with principles for fiscal reorganization recommended to the authors of the Report by a special Advisory Committee on State Accounting Policy and Procedure of the Illinois Society of Certified Public Accountants.

Simplification of Disbursing—Recommended but not Approved

The Reorganization Report stated that there is "unnecessary duplication in disbursing procedure between the Auditor and the Treasurer, without making either office a true check on the other"; "experience indicates that this duplication does not prevent fraud"; that "central preaudit because of tremendous volume becomes little more than a perfunctory clerical check."

Since the preparation of warrants by the Auditor is practically his sole remaining function, it was recommended that the office be done away with and the disbursing function centralized in the Treasurer. This would require a Constitutional amendment. This recommendation was endorsed by Governor Stratton and by the present Auditor, Elber S. Smith. However, the Genera Assembly did not approve it fo reference to referendum. The Au ditor of Public Accounts therefo continues as an elected constitutiona officer, responsible for preaudit c receipts prior to deposit in the Trea ury, examination of vouchers fo expenditures, processing and issuan of warrants in payment of suc vouchers (after recording and cou ter-signature by State Treasurer accounts and reports incident to the functions, and administration of th Municipal Auditing Law.

Summary

It is obvious from this review th there has been enacted in Illinois le islation basic for improved fiscal co trol and that a materially strong framework has been established f the financial administration of th State. The potential benefits of th legislation of course can only be rea ized by competent appointments the various commissions and offic and wise administration of the law enacted. Based on the steps thus f taken, and the evidence of hig intent of the administration and th General Assembly, a strong feelin of optimism as to the ultimate result is justified. The continued intere and cooperation of Illinois accoun ants will be most valuable in makin this important venture successful

ACCOUNTING THEORY AND THE COSTING OF ASSET CONSUMPTIONS

WILLIAM L. CAMPFIELD

The rapidly increasing stature of the public accounting profession has in recent years been accompanied by intensified attacks both on the profession and on the fundamental propositions that lie at the heart of accounting method. Many of the critics voice the sentiment that accepted accounting principles and methods are significantly deficient in furnishing information regarding the dynamic nature of business, its direction, its velocity, and its internal strength.

Other critics, fretting impatiently at the profession's hesitancy in adapting accounting techniques to price level changes, sound dire warnings that the public at large will begin to lose confidence in accounting and in financial statements unless the latter give a reasonable approximation to "facts" as expressed by price levels.

The present day rush towards statistical manipulation of costs of consumed assets reminds many present accounting practitioners only too well of the clamor of critics in the 1920's for the adjustment of outdated cost figures to the more "realistic" replacement value figures eventually adopted by many corporations. These practitioners remember equally as vividly the wild rush to write down these figures to a more "useful" level in the 1930's.

The pendulum has swung once again and public accountants hear the imprecations, the record of history notwithstanding, of those who would pressure them into yielding to business expediency. During the past decade, a combination of rising prices and increasing rates of income taxation appears to have given birth to a whole school of apostates who would accommodate the expediencies of certain business managements.

It is the purpose of this paper to examine briefly a few of the fundamental propositions of accounting theory as they pertain to an orderly and logical scheme for distributing plant and inventory investments to cost of production.

Since accounting is passing through the familiar stages of correlating theory and practice as experienced by other and older professions, it is fitting and proper that the professional accountant, as the primary custodian of accounting science, should be called upon to accept the challenge of reexamining from time to time his traditional concepts. He is well aware that his traditional concepts had their genesis in reason. It is incumbent on him to demonstrate convincingly that these reasons meet the test of present day challenge by dynamic business enterprise.

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The Rationale of Accounting

Accounting methodology, like any other method of rational human beings, must be guided and motivated by some basic philosophy. Basic philosophy or purpose stands out clearly and distinctly as the one force ascribing meaning to the actions of an individual or a group of individuals. It is the unifying factor in whatever we do. Accounting method has usefully served business enterprise over the centuries because it has permitted a factual and objective crystallization and quantification of all economic relationships and statement of them in numerical terms in such a manner that business results are presented in a more definitive and easily comprehended fashion.

Accounting employs the quantitative method of scientific analysis. Hence, during the entire course of assembly, classification, and reassembly of economic facts, accountants must be certain that the basis on which the facts are handled is constant. This is a cardinal principle underlying the scientific method. It is best typified by a fundamental admonition of mathematicians, namely: the unit in which a problem is expressed must remain the same throughout the calculations if a correct solution is to be obtained. If the accounting method, which partakes of all the attributes of scientific methodology, is to serve effectively as a guide for management in charting the direction of an enterprise, then there must be an adherence to the facts (bargained economic transactions) as they successively occur and in the lawful money of the time of occurrence.

In general, the purpose of accounting can be restated as oriented to the efforts of economic enterprise t produce net income or its equivalent Income is of concern to everyone Indeed, as has been repeatedly ob served, it may well be considered the greatest known motivator o human conduct. Determination o net income by conventional accoun ing processes is in agreement wit the concept of net income or prof by society as a whole, special purpos concepts of economists and others t the contrary notwithstanding. Basi therefore, to an understanding of determination of net income is reasonable concept of investmen outlays, that is, expenditures an their purpose. It is generally agree by all persons familiar with th rationale of economic enterprise tha expenditures are planned outlays fo the purpose of inducing predictab present or future income. Inasmuc as the traditional view of busine income is based on "a recovery money investment" concept, a de termination of that portion of ex penditure or cost outlay which is be charged to current revenue an that portion which should logicall be deferred to operations of futu periods lies at the very heart accounting purpose and methods.

It has been well stated that th accounting method of treating co or investment outlays embraces thr stages: (1) initial recognition, mea urement, and classification; (2) tracing of subsequent internal mov ments and regroupings; and, (3) final matching with revenue in th present or some future fiscal period In tracing the above stages, accoun ing methodology calls for an appo tionment of the deferred outlay cos

[1] W. A. Paton and A. C. Littleton, *An Intr duction to Corporate Accounting Standar* American Accounting Association, 1940, page

atably and equitably against revenues of several accounting periods n accordance with and in proportion o benefits bestowed in producing uch revenues.

It is well to constantly bear in nind that accounting measurement oes not purport to present a faithful eproduction of present value of noney outlays. From the inception f an economic enterprise and thereafter through its operating life, funds nd properties flow into the enterprise from owners, creditors, customers, or other sources all stated n the dollar amounts expressly or mpliedly set forth in the transaction ontracts. Since an essential need f management is to have adequate nformation on the status of investment outlays at all times, the accounting records of transactions must, if ney are to possess factual dependbility, be expressed in the same erms and measure.

Likewise it must be remembered nat accounting measurement does ot, in the majority of cases, adhere o precise or finite determination as the case of the exact sciences. After the original recordation of ctual cost outlays, remeasurement nust generally be somewhat of an stimate though based upon a wide ange of experience. However, if neasurements are carefully performed in the light of all available acts pertinent thereto, the expreson of the effect of enterprise transctions should approximate as nearly s humanly possible statements of act.

The framework of accounting measrement and interpretation is built round a foundation of accounting rinciples, conventions, and rules. ver time, society as a whole has given its tacit endorsement to this framework. The accounting superstructure, toward which critical opinions are frequently directed, has been predetermined by these principles, conventions and rules. Since the differences between accountants and their critics more often than not are differences in basic definitions, assumptions, and philosophy, critics of accounting methodology are well advised that all interpretations of accounting data, in order to be valid, should be viewed in the frame of reference of basic accounting philosophy.

Since the enterprise investment in long-lived plant and in inventoriable goods is significantly affected by methods of accounting apportionment to revenue, we now turn attention to a reexamination of accounting concepts underlying inventory pricing and depreciation accounting.

The Inventory Pricing Problem Revised

There are at least three places in the flow of inventoriable goods through an enterprise at which a decision about the price to be used must be made. The first has to do with the amount of the charge to the inventory accounts at the time of acquisition; the second point is at the time of recordation of issues from the stock of goods; and the third is in the determination of a figure to represent the goods on hand as of the close of an operating period. Hence, the inventory pricing problem can be viewed as being divisible into two interdependent but distinct aspects: (1) the process of apportioning costs to periodic revenues, and (2) the more traditional task of dif-

ferentiating between deferred charges for balance sheet purposes.

As indicated earlier, the basic accounting philosophy requires that cost outlays be distributed between accounting periods in some reasonable and rational manner. Consistent with this idea, a major objective of accounting for inventories should be the proper determination of net income through a process of matching costs of expired goods against the revenues which they benefited. Under this procedure, inventory at any given date would be a residual, that is, an amount remaining after the matching of absorbed costs with relevant revenues.

Many of the advocates of special methods of inventorying have contended that the method which best helps management establish selling prices or more nearly represents the profit available for dividends, etc., should be the method followed by accounting. The manner in which an enterprise determines its selling prices or determines the amount or manner of dividend distribution is not a matter to be settled exclusively through application of accounting methodology. Adherence to accounting theory will require that investment outlays in inventoriable goods be measured in the first instance in actual prices bargained, not hypothetical prices, and thereafter these purchase prices be allocated to revenue on the most equitable and logical basis of contribution of these costs to revenue produced.

Where goods are purchased in a condition ready for sale, the problem of pricing these goods is not overly complex. On the other hand, the determination of residual cost to be assigned to goods on hand as result of partial or complete pro cessing by the enterprise often pre sents a variety of problems of ap portionment of costs. For exampl the expense of idle facilities, exces spoilage of goods during productiv processes present possibilities of ab normalities which should be sepa rated in such fashion that none o the cost pertaining thereto shoul be applicable to or assignable to th goods on hand.

There are several assumptions a to flow of cost factors, for exampl first in—first out; last in—first out average cost, etc., all of which ar accepted by the public accountin profession as methods from which management may validly make a appropriate choice. Whether a give method is suitable to a business ente prise is to be determined by referen to the criterion of whether the met od adopted for apportioning the co to revenue is in harmony with o servable conditions surrounding ar existing within the given enterpris Typically, this flow of cost items a business enterprise is processio like with the most recently acquire items being the ones on hand as the close of a given operating perio While the accounting method dea with money figures rather than wi physical things, it is to be expecte that the method of cost allocati adopted should faithfully reflect t existing array of productive factor

It is submitted that, in an order run business, management visualiz its decisions in sequence. A manag ment makes a commitment for goo based upon an anticipated futu market for the goods which will profitable on the basis of acquisiti

rices current when the goods were urchased. Since selling price ex-ectations are reflected in a man-gement's decision to acquire goods, would appear logical that when articular goods are sold the ex-ectations associated with them in e form of their cost or acquisition rice should disappear also. Thus, e remaining goods for inventory present the acquisition cost side of e coin of deferred expectations.

Where the cost outlay for goods s lost its usefulness as a contrib-ing factor to revenue production departure from acquisition cost is arranted. While some of the factors dicating loss of usefulness can be termined with a high degree of jectivity, other factors require a rge degree of value judgment. The termination of physical damage to ods or obsolescence of goods can made fairly objectively. However, e determination of the money nount to be assigned to the measur-le damage or obsolescence is heavily vored with subjectivity. There are me objective sources for obtaining formation to use as a basis for praising the money loss assign-ent. The existence of a scrap mar-t where price quotations for the rticular obsolete or damaged goods uld be obtained is an example. gain, an insurance coverage on maged goods would represent an jective source for obtaining in-rmation to evaluate the fairness of e money figure assigned by a man-gement to the inventory loss.

In all cases where a management s departed from outlay cost to flect what is termed "recoverable st", a professional accountant re-ewing management financial representations should carefully examine all of the objective factors surrounding the particular case. On the basis of his knowledge and experience he should appraise the "recoverable cost" judgment of the management in the light of whether it does in fact represent a judgment as to the only part of original cost outlay that has a future revenue producing potential.

In appraising a management's pricing of inventory items and the associated cost of goods sold, the major criterion of propriety should be closely associated with the very nature of the accounting method. That is, it must have systematic regard for the statistical characteristics of double entry accounts. This means that, as a standard or preferred treatment for pricing goods into and through an enterprise, a consistent "into and out of the inventory account pattern" must be followed. The establishment of a standard or preferred treatment has the salutary effect of furnishing both the independent accountant and readers of financial statements with a benchmark or guide from which departures in inventory pricing might be justifiable where individual circumstances warranted.

The ideal pricing of the movement of goods through a business would be an identifiable cost method whereby each unit would be priced into the inventory account at its cash purchase or production price and would be priced out at the same identifiable figure. However, such idealistic situations exist in but few enterprises in a modern complex industrial society. The costing of goods into a business at their acquisition price

presents but few problems. But once goods have been acquired they become intermingled in such fashion that specific identification becomes generally impossible and the pricing of outflows must of necessity be based upon some type of assumption as to the flow of the cost factors through the enterprise.

In the foregoing circumstances, it is generally agreed that one assumption as to cost flows is as good as the next as long as it is in concordance with the observable typical circumstances of a given enterprise. As pointed out earlier in this paper, a first in-first out flow is typically in accord with a management's sales price expectations when goods are purchased. Hence, a professional accountant's standard for appraising a management's inventory pricing policies should establish as a preferred basis the pricing of withdrawals from inventory at the earliest acquisition price still represented by goods on hand, and a preferred basis for pricing the list of items on hand at the close of an operating period should be the acquisition price of the latest items acquired to the extent that such latest acquired items are still on hand at the inventory date.

With the above type of standard in mind, the accountant's judgment is immeasurably improved for then he is in position to establish gradations of departures from this standard which may acceptably, in his objective opinion, fit the circumstances of a given case. One writer has established a series of such gradations which might well furnish a scale upon which departures could be weighed. These variations or gradations of inventory pricing are as follows: (1) necessary, (2) acceptable, (3) questionable, and (4) rejected.[2]

Within the first group are departures from cost occasioned by writing down goods whose serviceableness has diminished because of damage, obsolescence, etc. or in cases where reasonable approximations of costs are used because actual cost is not ascertainable. In both of such cases adequate disclosure of the facts should be made. The second group would be typified by instances in which convincing evidence could be produced that a cost outlay for goods cannot be recovered. For example, where the potential sales price of identified goods has fallen below the cost price and convincing evidence exists that the differential between cost outlay and the lower sales price can not be reasonably recovered, it is obvious that the excess portion of cost should be written off as an acceptable departure from a continuance of pricing the inventory at acquisition cost. The third category of departures would embrace the cost or market rule and all other variants used because of financial considerations or desires to accomplish apparent stabilization of profits through inventory pricing policies. The last category would refer to any of the schemes for costing goods at a price higher than the acquisition outlay for such goods.

By proceeding from a standard or preferred basis for pricing inventories, a professional accountant would be in a position to clearly support any opinion of his which accepted certain variations by a management from the standard. He would also be able to indicate clearly the limits below which variation

[2] A. C. Littleton, "Inventory Variations", *The Journal of Accountancy*, July 1941, pages 13-15

ould not be acceptable. For example, variations in the first and cond categories cited above might ell be acceptable provided they ted the circumstances in the individual case. Variations in the ird category might well call for qualification in the accountant's ritten opinion. Variations in the urth category would in all likelihood entail a withholding of the countant's opinions if the inventory was material enough to affect anagement's financial representaon as a whole.

Compatible Concept of Depreciation Accounting

The problem of accounting for depreciable fixed assets has become in odern times an important one because of the increasing large scale vestment by industrial enterprises plant and equipment. In periods rapidly fluctuating prices the roblem becomes even more acute for ere is frequent importuning, under e banner of aid to management ecisions, of accountants to give approval to multifold variations of the nventional depreciation accounting ethodology.

A professional accountant in his praisal of a management's depreciation methods is well advised relate his actions to some aspect the basic accounting philosophy entioned earlier in this article. In is manner the question of what rovision is necessary to cover the rvice expiration of plant is a matr dependent solely on the cost utlay of the plant, the nature of ne properties, and the conditions nder which they are worked. Consistent with basic accounting cepts, the problem of depreciation accounting is divorced from the financing of plant replacements, dividend policies, profit stabilization and the like. All of the latter are real problems for a management, but like many other problems facing management they can best be resolved by launching the solution from a platform of factual or objective financial data.

Depreciation accounting can be thought of as that part of accrual accounting whereby actual cost outlays for physical plant are assigned to successive fiscal periods on a basis of the total service life represented therein. A noted author points out that a most useful concept of the nature of the depreciation problem is that which views the amount of the investment in an asset with a terminable life as a capitalization of the value of the future service to be rendered by the asset, and depreciation is viewed as the amortization or expiration of the investment as the services are realized.[3] Depreciation expense is for all intents and purposes thus very much similar to a service charge or a contribution made to production.

A theoretically ideal method of distributing plant cost outlay would result in each unit of output bearing its just proportion of the burden. Under the ideal method the life period of the asset would be viewed as a whole and its total cost distributed equitably over the entire output, all other conditions remaining the same. But in a world somewhat less than ideal and hence precluding a perfect preview of future output, a business management must search diligently for the depreciation

[3] Perry Mason, *Principles of Public Utility Depreciation*, American Accounting Association, 1937, p. 2.

method or methods which most nearly are in accord with the useful service life of investments in plant.

In depreciation accounting, as in other areas, usefulness is neither an absolute nor a completely objective concept. Useful life in properties does not always continue until a property is completely exhausted, nor does it necessarily end when the unit ceases to be the most useful one available. Somewhere in between these two extremes useful life ends. The problem of determining just where usefulness ends must be solved by management in the light of circumstances surrounding the particular business enterprise.

The professional accountant in making his appraisal of the propriety of a management's depreciation methods can find his clue in the basic philosophy underlying depreciation accounting. It is to be recalled that cost outlays or investments are made by a management to induce revenue over a period of time. Depreciation accounting is a method of assigning plant cost to revenue on some basis which equitably relates the service contribution of the investment to the product for whose benefit the investment was made. Hence, useful life of cost outlays should be viewed in terms of the creative effort remaining in the investment. This means that periodic observation must be made to ascertain the effect of productive use on the investment. In crystallizing his judgment about the propriety of depreciation methods used by a business enterprise, the accountant will rely on such things as engineering estimates and appraisals of the productive potential remaining in plant investments, and on his own knowledge of events outside the confines of the particular enterprise which suggest imminer impairment of investment, e.g., con petitive use of new processes, etc.

A "useful service life" concept c depreciation accounting and a cor cept of depreciation expense as cost of service used require tha accountants view with scepticism an failure to restore to an amortizab basis any material item of plant co which retains service contributio possibilities. Depreciation accountin at best is based upon an estimat an informed one to be sure, and a estimates connote the existence some force or forces which subs quently will furnish a basis for val dating the estimate. A critical r examination of depreciation charg must be made from time to time accountants are to assure that a counting for depreciation and perio ic net income determination will as fair and reasonable as human possible under the circumstances.

In recent years the whole proble of depreciation accounting has be subjected to an inordinate amou of criticism from persons interest primarily in the matter of providi funds for replacement of pla property. Few accountants are u sympathetic to the need of manag ments to devise ways and means retaining adequate funds to hed against the uncertainty of prices the time plant is to be replace However, accountants should not fo get that the accounting methodolog is an orderly, integrated proce which has an objective of presentir factual data about an enterprise.

Professional accountants shou stand ready to use their most co vincing persuasion to bring manag ments to the viewpoint that abnorm circumstances can be met witho disturbing the logical relationship

ıe data encompassed by conventional epreciation computations. Manage- ents can make intelligent judg- ents regarding the financial needs f their businesses through having factual accounting record of total ant investments and unamortized vestments. Logical decision-making rarely achieved in circumstances here factual transactions are dis- rted through first one statistical ostrum and then another. Moreover, has yet to be convincingly demon- rated that a mere change in the ethod of recording financial data as, in itself, ever produced funds r a business enterprise.

UMMARY

It is widely agreed that one of the asic propositions underlying all ccounting methodology is that it presents an orderly and factual ay of determining business net in- me. It is also well known that the nount of net income of a business ay vary considerably depending on the views, habits, or predilec- ons of the management of an enter- ise and/or of the professional ccountant who reviews a manage- ent's financial representations.

In determining the net income gure to be presented in the financial atements of an enterprise, managers e required to make many decisions, me of which may be derived from finite facts and objective measure- ents, e.g., historical investment out- ys, dates upon which transactions e completed, consistency of proce- ures for apportioning cost outlays, c. Other decisions must of necessity based on subjective measurements, g., estimates as to the length of eful life of assets, assumptions as the most realistic pattern of cost flow, the degree of materiality of items in relation to the propriety or reasonableness of given accounting assumptions.

Management must have as many factual bases as possible in order to arrive at intelligent decisions. Accounting methods and procedures therefore must produce results which are logical and consistent with a body of carefully reasoned concepts as to accounting purpose and accounting objectives. Accounting has been useful through the ages because it has logically, factually, and objectively presented the quantitative factors of economic transactions in a way to be easily understood by all reasonably prudent parties who use such financial data.

This paper has presented a brief re-examination of basic accounting concepts particularly as they relate to the fundamental propositions underlying the apportionment of investments in long lived assets and the matching of the expired costs of inventories with the revenues which they induce. In recent periods, the stress of high taxation rates has influenced many people to look upon depreciation charges and cost of goods charges as two major means of obtaining maximum short range tax reductions. Often, these short run expediencies are accomplished at the expense of long run planning and control of enterprise profitableness.

Net income determination under actual cost theory ties accounting closely to the concept of net income held by society as a whole. The results of any discipline are judged from the standpoint of society as a whole—not solely from the standpoint of some one or a limited group of interested persons. A coherent body of accounting theory is needed, there-

fore, to ascribe meaning and purpose which is understandable and useful to all members of society. Without a cohesive framework of theory within which more and more useful generalizations can be made and in turn applied to specific problems, accounting techniques are likely to be dry and superficial. With a consistent, carefully reasoned body of doctrine, accounting practice can adequately serve as a safeguard against wilful or arbitrary manipulation of net income. While the impa of economic change has occasione the need for more financial data an greater interpretation of data tha ever before, these needs can best b fulfilled through careful analysis an interpretation of the results pr duced by an orderly and objecti methodology—not through sophist cated variation of the methodolog to conform to the illusory and oft whimsical desires of some critics.

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

DIVIDE TO CONQUER ?

[t is frustrating in dealing with risive reorganizations, and more rticularly with so-called spin-offs, be confronted at the outset with startling realization that a spin- may not be a reorganization at even though it wears the cloak l trappings. With that as an open- caveat, the approach will be to mine some of the byways and shoots of the spin-off transaction, contrasted to a line by line dis- ssion of the Code's provisions. fore getting into these things, let's ine the spin-off: It is character- d by the distribution of stock in controlled corporation (already sting or newly created), to the reholders of the old, that is, the tributing company, without the reholders giving up any of the ck of the old company.

oad Requirements

Now for a look at the broad re- rements and restrictive features the spin-off transaction, avoiding the moment, the fine points: The parent and subsidiary com- nies must have been engaged in an ive trade or business for five years or to the date of distribution. The parent and subsidiary companies must be engaged in an active trade or business (with the same shareholders) immediately following the distribution. (3) The plan must not be a tax avoidance device—that is—a scheme to distribute earnings. (4) Bondholders may not participate in a spin-off. (5) The distribution by the parent (old) company may be from 80% to 100% of the stock of the subsidiary (spun-off) company. However, if tax avoidance can be imputed by less than a 100% distribution, then the requirements of the Code (Section 355) are not met. (6) The distribution among the shareholders of the stock in the spun-off company need not be pro-rata. (7) The distributing company must meet the so-called 80% stock control test.

Corporate Business Reasons for Separation

Why should a business be separated? In most cases good business reasons exist—and almost always the thread of tax planning runs through the business reasons. Some examples of business reasons, and these are not by any means a complete run down, follow: A combination of unrelated businesses makes it desirable

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for economic and efficiency reasons that a separation be made; or there may be stockholder and hence management friction within a corporate entity that for the good of the business requires separation of the shareholders and the businesses; or in terms of public relations within a community it may be advisable for a large company to divide and leave the local business with local shareholders; or tax savings in terms of local and state income, franchise, intangible and other types of taxes may be achieved by the separation (it is highly questionable whether a saving in federal income taxes is a good business reason); or avenues may be opened for attracting new outside capital. For illustration, a prospective investor may not be able or willing to invest in a large enterprise because of putting him in a minority position, or with a group of shareholders he wants no part of; or younger management may not be able to buy into or otherwise acquire a part of a larger business. In order to hold personnel, a separation giving the younger group a chance to acquire stock in the spun-off company can be accomplished; or charter restrictions may require the formation of a new company to take over a phase of the business.

Tax Advantages

Almost always the refrain runs that good corporate business purposes dominate the separation and that tax considerations are incidental. However, the hand and glove approach does not always allow for a precise appraisal of the relative weight to be accorded each. With this in mind, an examination of some of the so-called incidental tax advantages is appropriate.

Obviously a new company or cor panies brings on the advantage a new climb up the tax ladder f each company. (Contrariwise, t separation of profitable and unpr fitable businesses may cause t losses of the unprofitable business go unabsorbed!)

The spun-off company can esta lish a new fiscal year without t Commissioner's approval. This len itself to enchanting possibilities terms of dividend and salary policie

Since distributions need not prorata it is conceivable that a lo company can be spun off to a selecte shareholder who could then mal judicious use of it.

The rule that the distribution the spun off company stock need n be prorata is intriguing. In a fami or closely held corporate structu the possibility of making gifts paying compensation through t spin-off is tempting and may abused. Even though there is statutory prohibition as is the ca under Code Section 351 (dealing wi transfers to controlled corporations it is unlikely that a nonprorata di tribution will hold up where it patently a device for making gif or paying compensation. A reaso able approach is always the ord of the day.

From the face of things, it appea that a spun-off company could sold anytime after the separation a thus allow the selling shareholde to establish capital gains witho releasing or reducing their intere in the distributing (parent) co pany. This entire area is cloud because the "intent" test comes in play. Nonetheless, in the prop circumstances, where the separati was divorced from any intent to s

s might be evidenced by lack of gotiations, correspondence, or any nilar background), the sale of the un-off company should result in capital gain transaction. Time is ways helpful in these situations. ius, a separation followed by a sale ree or four years later looks better an a separation followed by a sale ree or four days later.

Estate planning can be both favorly and unfavorably affected by in-offs. Valuation problems beme rampant. A big question is nether the shareholder will end up th a greater overall valuation of ock in several active companies an with stock in one company. Imrtant too, will an estate's qualiation under Code Section 303 be ssipated by the spin-off? Under ction 303, the estate may redeem ock in a corporation without the putation of dividend construction, the redemption does not exceed e amount of estate and inheritance xes and certain expenses of adnistration, *provided that* the valuon in the estate of such stock rms 50% of the taxable estate or % of the gross estate. A separtion may disqualify both the new d old stock under Section 303 her by way of not meeting the gregate 75% percentile test for the ock in both companies; or if the areholder owned less than 75% of e stock of the distributing (old) rporation in the first instance, its valuation by the spin-off might no ger qualify it under Section 303, suming, of course, that it met the % and 35% arithmetical tests in e first place.

Also, as was stated earlier, a disoportionate distribution has a posle built-in method of estate disation without gift or estate taxes.

Active Trade or Business

It would be well to return to the technical phases of the statute and regulations with emphasis on the subtle and unanswered. The first requisite for a spin-off is that the parent and subsidiary companies must have been engaged in an active trade or business for five years prior to the date of distribution and immediately following the distribution. If there is no subsidiary but it is the parent that is being broken up, then the parent must have been in more than one active trade or business for five years prior to the distribution.

What is an active trade or business? This question will be kicking around the courts for a long time to come. The Regulations state, in general, that a trade or business consists of a group of activities carried on for the purpose of earning income or profit only from such group of activities, and the activities included in such group must include every operation which forms a step in the process of earning income or profit from such group. Such group activities must include the collection of income and the payment of expenses.

The Regulations specifically exclude from a trade or business the holding for investment purposes of stock, securities, land or other property. There is no real quarrel with the Commissioner in this area and, he will undoubtedly be ultimately sustained in this Regulation. A Revenue Ruling indicates that a minor amount of these types of assets transferred in connection with another business that could logically be separated, will not in itself destroy the tax free nature of the separation.

Also excluded by the Regulations is ownership and operation of land and buildings all or substantially all of which are used and occupied by the owner in the operation of the business. This one presents controversial points. In the first place, it is not realistic to prevent such a spin-off. The same result, it has been suggested, can be accomplished by transferring the property to a wholly-owned subsidiary, allowing it to operate on a rental basis for five years, and then spinning it off. In short, the Regulations merely cause the taxpayer to take artificial means to accomplish a result. Of course what the Commissioner is trying to prevent is a transaction that has the effect of an exchange and leaseback. Important too, is the terminology that all or substantially all of the property must have been used in the trade or business in order to *disqualify* the spin-off. The reorganization cases may be looked to for a determination of the meaning of the term "substantially all". However, the transfer of real estate that is integral to a business being separated should qualify. Thus, the separation of an operation in another state, even though the operation is similar to that of the parent, should qualify including the transfer of real estate and plant of the separated business.

The Commissioner puts the damper on the separation of a group of activities which, while part of a business operated for profit, are not themselves independently producing income, even though they could produce income with increased activities or additional activity. Although the Commissioner's objectives are laudable, this area of restriction is bound to create difficulties. The Regulations have in mind such things as captive mines, research operations, land us as a company parking lot, and si ilar items.

Continuing to accentuate the neg tive as to what does not constitu a trade or business, some other p hibited or imponderable areas be comment.

A business cannot be split do the middle into two businesses a qualify. There must have been m than one separable business to st with. Further, in an integrat manufacturing business, the selli cannot be separated from the ma facturing.

Suppose the business *that is tained* was not in operation five yea does that disqualify the separatio Putting it another way, a compa has three different businesses, t of which are over five years old a one which is three years old. It sp off the two businesses more than f years old and continues to oper the three year old business. D the separation qualify? This is imponderable. Again, how long af separation does a business have stay in business? For example, separation is made that quali under all of the rules, but is t liquidated six months after the se ration. Although there is no answ the shareholders would be invit the Commissioner to tax the liqui tion proceeds as an ordinary di dend. The Commissioner, since stresses continuity after the dis bution, would surely say that transaction was one conceived distribute earnings and profits. H again, the biding of time bef liquidation may be the best ar ment in defense of the liquidati

In separating a business, the ass transferred should be reasona identified with the business be

ransferred. Often, assets for sepa-ate businesses are used in common. 'here is frequently a common cash ccount, a common inventory ac-ount, a common supplies account, tc. It would be unwise to separate 1 the spun-off company a dispro-ortion of highly liquid assets such s cash. The Commissioner, in such ases, is more than likely to say that ie spin-off did not qualify generi-ally, and, should the spun-off com-any later be sold or liquidated, that ie entire transaction was a scheme or siphoning off earnings and profits. ll of this points up the desirability f maintaining accurate records and udgets to facilitate the transfer. Vhat is more, with good bookkeep-ig, the allocation of surplus to the pun-off company might be on a recise basis rather than on the rela-ve ratio of the asset values of the ssets spun-off and those retained.

In dealing with the problem of ie nature of the business for the five ears preceding spin-off, normal hanges in the business will not dis-ualify the requirement that the me business was carried on for the ve years. Thus, the dropping or ldition of a product in the normal ourse of events would not work a isqualification. An intriguing ap-roach to this problem would be the se of the Commissioner's Regula-ons on the changes in the character f businesses necessary to qualify or Excess Profits Tax Relief under Vorld War II tax laws. In those tuations he argued quite strenu-isly, and with much success, that o obtain relief a change in the haracter of the business need be pro-ound. This is an opportunity to ossibly turn the tables.

The trade or business being separated must not have been acquired in a taxable transaction within the five year period immediately preceding the distribution. Tax free acquisitions qualify, including acquisitions of companies formerly operated as proprietorships or partnerships during the five year period. On the other hand, if there was the intervention of a taxable transaction, even by a stranger, the acquisition would not qualify. An example would be a company acquired in a taxable transaction within the five year period by a stranger and subsequently acquired by the distributing company from the stranger in a non-taxable transaction in the same five year period. Interesting possibilities suggest themselves with respect to acquisitions that are partially taxable and partially non-taxable; or to acquisitions part of which were made during the five year period and part without the five year period.

Tax Avoidance

A few comments about tax avoidance! Code Section 355 speaks of tax avoidance in two instances. It first deals with the point that the distribution must not have as its principal purpose the disguised distribution of profits and earnings. If tax avoidance can be imputed, the tax free nature of the spin-off is endangered. The obvious scheme that was meant to be plugged was the distribution followed by a prearranged sale. But since the statute is liberal in this interpretation (although the Commissioner will not be), the next most apparent tax avoidance device that comes to mind is the liquidation of the spun-off company. This situation will have its day in Court and

stand or fall on the facts in each case.

The point has been raised as to why there can be a preconceived partial liquidation of a corporation with capital gain consequences and yet, under substantially similar facts, a spin-off followed by a sale might result in ordinary income. It appears, however, that there are some differences: In a partial liquidation, if the sale of the distributed assets is negotiated prior to the distribution, the Commissioner could well argue the double tax theory under the *Court Holding Company* doctrine. Also, it appears that in a partial liquidation a genuine contraction in the business may be a requirement. This is not true of the spin-off.

Code Section 355 then lays down the requirement that, if less than 100% but more than 80% of the stock in the spun-off company is distributed, the stock retention must not have as its principal purpose tax avoidance. It is not clear as to when tax avoidance will be imputed under these circumstances. It is clear, however, that the Commissioner will insist on a 100% distribution in practically every case.

The Commissioner has extended the Statute by his Regulations by holding that the spin-off, despite the fact that it may not be a reorganization, must meet the "good corporate business purpose" test. Undoubtedly, he will be upheld by the Courts. It is important, therefore, in every spin-off transaction to establish a good corporate business purpose as distinguished from good stockholder business purpose. Some of these purposes have been mentioned earlier. The mere fact that the active trade or business rule is met does not mean in itself that the good corporate business purpose test is met.

Distribution

As the last leg, here is a run dow on some of the technical problems distribution: If all of the commo stock of the spun-off company is di tributed in proportion, aside fro the allocation problem, there see to be no tax complexities. Where th distribution is not prorata, tax pro lems may be lurking. From a corp rate standpoint it would be well, such cases where a technical reo ganization is required, to meet a of the reorganization provisions d spite the fact that the *general stat ment* is made in the Senate Finan Committee reports relative to th 1954 Code that a reorganization not required. If all of the preferr stock (including dividend arrea ages) of the spun-off company distributed in proportion, aside fro allocation problems there are al no immediate tax complexities. No prorata distributions will be suspe Moreover, the preferred stock ma become tainted "306" stock with a of the attendant headaches. A stoc holder can receive tax free *on* stock of a spun-off company. If receives bonds (securities) or a other property it is taxable as boo If property other than that reco nized as tax free is distributed, it either taxed as boot under Co Section 356 or destroys the enti tax free nature of the distributio depending on the nature of t transaction.

Earlier mention was made acquisitions partly taxable and part non-taxable within and without t five year period. For example controlled company is owned 90 for more than five years and in taxable transaction within the fi years the 10% remainder of t

ock is purchased. The 100% owned mpany is spun-off within five years the 10% acquisition and 100% the stock distributed. The fair arket value of the 10% stock is xed as boot.

The boot in all cases is treated as dividend provided the stockholder's table share of earnings and profits the *distributing company* is sufcient. If the boot is in excess of the stockholder's share of the earnings, it is treated as capital gain.

It was not meant to touch on all of the problems and niceties in the areas covered, and many items such as the matter of control, allocation of earnings and profits to the separated companies, stockholder allocation of investments, have not even been mentioned.

RECRUITING AND COMPENSATING STAFF PERSONNEL

R. T. Herkner

"Personnel is the axis around which success revolves unceasingly; a capable staff inspires confidence and pride, assures security and profit, and, what is more important, provides time and talent for development of new and broader business, thus widening the field of service. Without a capable staff any engagement is fraught with grave danger, and still greater risks prevail if the staff is dissatisfied and unhappy, or loses faith in its firm and confidence in its manager."

The above quotation by Mr. Miller Bailey, C.P.A., retired partner of a national accounting firm, eloquently expresses the importance and the magnitude of the responsibility resting upon the shoulders of the person or persons in any public accounting firm charged with the responsibility of recruiting and compensating staff personnel.

An examination of literature on this subject published prior to World War II will disclose practically nothing of any consequence dealing with this particular problem. At the inception of World War II, however, the demand for accountants increased sharply. The government needed accountants, both in its civilian and military departments. Industry needed accountants to meet its a counting obligations under war co tracts and other government regul tions. Public accounting firms need accountants because their proble were multiplied by clients' deman for additional services, and by t impact of confiscatory taxes on i come. This situation for the first ti brought into sharp focus the sho supply of trained accountants a the tremendous demand for th services occasioned by the warti economy. We have since found th this condition was not mitigated any substantial way by the cessati of hostilities. The burgeoning ec omy, stimulated by shortages civilian goods resulting from the w a gradual upward trend in popul tion, an expansion of services re dered to clients by CPAs, and continuing demand on the part industry and of government f trained men to carry on work und a peacetime economy, all added to a condition of extreme shorta of qualified accounting personnel t like of which has not been seen sin the birth of public accounting as profession.

For the first time the personn manager of the public accounti firm found himself face to face wi

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ıe problem of recruiting adequate aff to meet the needs of increased ɔerating schedules. In the man-ɔwer market place he suddenly ınd himself in competition and, I ight say, keen competition with ıdustry and with various adminis-rative departments of government. ɔ him this suddenly became a new ıd indeed an exceedingly enlighten-g experience.

The purpose of this paper is to tamine in some detail the general roblem and to examine concrete ays of dealing with it. National ms of certified public accountants course have been most effective meeting the situation; their prob-ms, in a sense, are no different om those of the smaller practitioner ıd essentially the methods, prin-ples, and techniques are the same. owever, in this paper it is proposed approach the problem from the andpoint of the medium-sized or ıall firm.

ECRUITMENT PROGRAM—SCHOOLS AND COLLEGES

One of the most important recruit-ent programs is that which attempts channel the high school graduates to the business schools of our lleges and universities with a view their becoming graduates with counting majors. Unfortunately r the profession as a whole, all ɔ little attention has been given this phase of recruitment during st World War II years. It is self-ident that, in order for a recruit-ent program for a specific firm to at all effective, there must be a ırce of material, and the main urces of such material are the aduates of the colleges, universities d business schools whose courses e of a high quality.

Only a few years ago statistics showed there was a noticeable trend of students away from the pursuit of accounting as a career; in fact, this trend became so noticeable that leaders in the field became alarmed to a point where concrete steps were taken by the American Institute and by state societies of certified public accountants to reverse this tendency. Various reasons for this apparent defection have been advanced. Some new and perhaps glamorous fields have recently come to the fore in the field of business, such as market research and analysis, financial analysis, new product market development, and foreign operations, to mention a few. There are those who feel that the profession of accounting is equally attractive, and that the real fault lies in some of the old bugaboos which still dog the profession, and which find a basis in past practice. Temporary employment, long hours, no pay for overtime, and unusually low pay in relation to the starting salaries in other employment, are some of the things which the older practitioners will recognize as long having been associated with the practice of public accounting. Whether we embrace the philosophy or not, the present day college graduate is more interested in the good life. He is interested, at least to some extent, in the security of his position. Many times he would much prefer to live in a medium-sized community where his family will have an opportunity to enjoy the social life which is found there. Having embarked upon a professional career, he likes to have a sense of being a part of that profession and its activities. It seems abundantly clear that temporary employment, long hours, low pay, and extensive out-of-town travel do

not square with the 1957 college graduate's philosophy of what he would like to find in his post college life. There are those in the profession who still look upon the employment of a junior accountant as something of a privilege extended to him, that it is indeed an honor that he has been selected for employment in this still young and rapidly growing profession. They would like to have him believe that he is in a far more advantageous position than, say, a young law clerk first starting out in his chosen profession. If there are those among you who still entertain this employment philosophy, I urge you to disabuse your minds of this archaic approach to the employment problem. Unless you do you can be assured that you will not fulfill your manpower requirements in the present day market for accounting talent.

Another of the professional bugaboos which, in my opinion, deters high school graduates from embarking upon a training career in accounting is the fact that some so-called public accounting firms really are not conducting a professional accounting practice as such; they are, in fact, substantially nothing more than public bookkeepers. No argument need be made for the proposition that, to the extent this exists in our profession, the high school graduate will hardly be stimulated to four or five years of further study to become, in effect, a public bookkeeper.

However, the present day situation really is not as black as one might think. The last two or three years have shown a reversal of the trend, and no small measure of credit is due to the Amercian Institute of CPAs for its aggressive progra It has provided a film, several boo lets and guides for high school a college recruiting, not to mention testing program and many oth things which it has done in a co crete effort to attract qualified st dents to the accounting professio While the American Institute c do much in supplying such materi and a real effort must be ma constantly by the State societies a chapters of CPA's, the most effecti recruitment must come from t large body of individual practitione who in this area have an outstandi opportunity for service, not only the profession, but to the econon community of which we are so mu a part. I would urge each and eve one of you to (1) talk to teache and to guidance counselors at eve opportunity about our professio (2) talk to individual students student groups who may be int ested in accounting as a professi and (3) cooperate in the internsh program of colleges and universiti A note of caution with respect this third item: endeavor insofar possible to make the work interesti and to give it some variety. From talks with students the internsh program has sometimes been a r factor in diverting otherwise p tential accountants into other fiel because of the monotony of the sing task assigned during their internsh experience. In short, the accounti profession is faced with the "ha sell". If it is to survive and render the services which have b come such an integral part of o economy, it must marshal its forc in a concerted effort to attract suffi ent numbers of college students the study of accounting so as

lfill the needs, not only of the pro-
ssion, but also of government and
ivate industry. It is not a fight
be staged in New York or Wash-
gton; boiled down to its essentials,
is a grass roots problem. Let us
t underestimate the size or the
ration of this undertaking; a crash
ogram is not the long-range answer.
One possible danger to which we
ould be alerted is that students
y feel that with the advent of
ctronic accounting the need for
countants will be curtailed. While
s may be true as to the clerical
pects of record-keeping, the devel-
ment of electronic accounting will
doubtedly open up a whole new
d challenging field where account-
ts of increased talent, skill, and
ining will be required in even
eater numbers.

ie Mechanics of Recruitment

We now turn our attention from
e broader aspects of the question of
ruitment of high school students
training in accounting in our
leges and universities to the more
ecific and immediate problem of
ruitment of personnel for our
pective organizations. There are
logical steps which must be fol-
ved in order for a firm's recruit-
nt program to be effective. They
:

(a) The assignment of responsi-
bility for recruitment

(b) The training of the recruit-
er in the techniques of interview

(c) The establishment and pro-
mulgation of personnel policies

(d) The communication of the
firm's story to the prospect

(e) The determination of the
criteria for hiring

(f) The interview follow-up

The Assignment of Responsibility for Recruitment

While all the partners or others interested in firm management should be interested in the recruitment problem, it is imperative that the responsibility for the recruitment program be assigned to a single individual. This does not mean that being in charge of the recruitment program must also require his doing the actual interviewing; this could be delegated to someone else. It should not be inferred that the interviewing of applicants is a routine part of the recruitment process; on the contrary, it is a most critical phase. It is at this point that first impressions are created which either can attract qualified employment prospects or can divert them to other employers. It is important, however, that the overall program be coordinated and directed by one person. Centralizing the responsibility does not mean that other partners should not have an opportunity to talk with prospective employees, in fact, it is desirable to arrange for visits of the interviewees to the firm's office so that they can have an opportunity to talk with other partners and key employees. It also is desirable to give them an opportunity to visit with others on the staff, especially those who may have been recruited from the same school.

The Training of the Recruiter in the Techniques of Interview

Many of us have found ourselves thrust into the position of the recruiters of personnel for our respective organizations without having had very much, if any, training in the techniques of interview. Much literature has been written on the

subject and for the person who has been charged with the responsibility of recruitment, particularly at the interview level, it is well to become familiar with this literature. Another possibility, of course, is to attend schools held periodically by industrial psychologists, which schools are conducted solely for the purpose of training interviewers. Among other things, interviewers should have a sound and complete understanding of how basic habit patterns are formed in early years, and how they manifest themselves in adult activities. The interviewer should plan a systematic coverage of the personal history; he should draw evidence from early school life, the individual's school record, his experience in military service, his social and home life, and his work history. At all times he must keep his judgment objective and, during the course of the interview, should make notes of responses to the various questions asked. These notes he then can compare with a predetermined list of criteria.

It is important that the interviewer conduct the interview on an informal and personal basis. The interviewee should be made to feel at ease, and for this purpose a conversational type of approach can sometimes be used. If the interviewee is inclined not to be talkative, however, a more formal questioning approach may be required, but in any event avoid any method of interrogation which smacks of an inquisition. As previously stated, the interviewer must have a complete understanding of the firm's personnel policies, and must be able to talk intelligently about them and to answer questions concerning them, because questions he will have, and probably the most pointed question will come from those students i whom he has the greatest interes

It is desirable to follow up th interview with further investigation this can be done by talking to th professors who have had the studen in class, with perhaps an occasiona discreet question directed at some c his campus associates. Of course, i he is going to be employed you wi want to make a careful investigatio of his references. Inasmuch as th employment process is importan from both the employer and th employees' standpoint, do not ove look the possibility of the use of consulting psychologist to supple ment or confirm your findings. Th should be done soon after employ ment; the fees for this service ar not excessive, and the service ma well save the harried practitione from wasting many hours of time i orientation and training.

There are available pattern inte view sheets which can be modified fc specific situations, but which, i followed, will elicit the informatio necessary to formulation of a judg ment as to whether the interviewe should be invited to join your orga ization.

The Establishment and Promulgation of Personnel Policie

Today's recruiter soon finds tha his interviewees ask him very pointe questions concerning his firm's pe sonnel policies; consequently, he mus be in a position to give forthrigh and candid answers to a whol variety of questions. In order t assist him his firm should establis and should make available not onl to him but also to its staff membe a comprehensive statement with r

ect to personnel policies. This ıtement probably would cover the m's policies on such diverse mat-rs as the following:

Frequency of salary increases
Frequency of advancement
Employment probationary periods
Causes for and methods of handling dis-ssal
Placement of released personnel
Time off on account of illness (sick pay)
for personal reasons
Time off to sit for the CPA exam
Payment for overtime hours
Allowance for supper money
Outside work
Offers of other employment
Duties and responsibilities of employees
Explanation of partnership possibilities
Military service
Vacation
Participation in professional meetings

ıe recruiter who is unable to state e firm's policies with respect to ch matters will soon find himself a distinct disadvantage in the ınpower market. Prospective em-ɔyees have a right to know your sition with respect to these various ıtters, and you can be assured that gue or evasive answers, or a state-ent to the effect that you have no licy regarding this or that item ll not elicit much interest on the rt of the interviewee in working r your firm. Present day college aduates are indeed sophisticated the matters of human relation-ps, and they are quick to recognize ɔse firms who still operate under e Dark Ages philosophy of person-l administration which character-d some of our profession prior to orld War II.

e Communication of the Firm's Story to the Prospect

One of the real drawbacks to ob-ıning a prospective employee's in-terest in your firm lies in the fact that he knows nothing about it. Most of the national firms use effective methods for enlightening prospects, but the small individual practitioner or the medium-sized partnership cannot afford to use printed brochures, pamphlets, etc., to convey its story to the interviewees. There are ways, however, that this can be accomplished. A firm scheduling interviews at a college or university should have in the Placement Bureau's files a letter outlining briefly the history of the firm, its personnel policies, the professional background of its partners, some indication of the kind and type of work performed and of accounts handled, a brief description of the provision for staff training, an outline of the advantages of living in the area or areas served by that firm's offices, a description of office facilities, and other things which a prospective employee would be interested in knowing about. In drafting such a letter, be realistic; in other words, do not oversell. To do so would probably result in a dissatisfied employee, and, if there is one such person on the staff, the feeling can spread to others.

Another means of promoting interest is to invite prospects to visit your office in the city to which you expect to assign them. Arrange for a luncheon with key supervisory personnel, thus giving them an opportunity to look over the prospects. Don't overlook an opportunity to have the applicants visit with other staff people, although this can be dangerous if your personnel policies are of a 1930 vintage!

The Determination of the Criteria for Hiring

Here is another important step in the recruitment program, and all too frequently one that is overlooked. Some of the things which should be considered in setting up criteria might best be indicated by a series of questions: How important is the prospect's scholastic record? Are there mitigating circumstances which may have had a direct bearing on this, such as full or part time work, illness or family considerations? What is his social record, both in high school and college? What observation do you have concerning his previous work history, if any? Should age be a factor in the consideration of an applicant? What about his military status? What about the student whose grade record is average, but the last year or two shows continuing improvement? Have you evaluated the personality traits which you would like to see in your employees? In this connection, where would you draw the line between a student with a weak personality and good grades and the student with a good personality but just an average grade record? Would you employ girls for the audit staff? If so, should their compensation be fixed at the same rate as the male staff members? Would you hire experienced personnel? All of these questions and many more must be answered in order to set up criteria for hiring, hence the person in charge of recruitment must establish these criteria in order to properly perform his function.

Having once established the criteria of hiring, they should be critically re-examined periodically in the light of changing conditions and on the basis of a study of the firm's experience with employees previously hired.

While the criteria for hiring serv a significant function in the employ ment process, they should not, unde any circumstances, be used as categorical check list. The occasiona exceptional person may not fit i with some of the hiring standard which have been set, but, overall he may make a good employee. Cer tainly your system should be suff ciently elastic to take into consider ation such exceptions.

The Interview Follow-Up

All too frequently the intervie concludes with the recruiter havin already determined that the prospec should not be considered for employ ment. Perhaps this conclusion ca be conveyed to the applicant at th time of the interview, but, if not, i seems only good public relations an good business etiquette as well tha a follow-up letter be sent informin him that for whatever reason he i not under consideration by your firn True, this takes extra clerical effor in your office, but you will find ov the long pull that it helps build goo public relations, not only among th employee prospects, but also wit the Placement Bureaus of the schoo with which you are dealing.

In the event that some of the pro pects are people you would be in terested in employing, your next ste should be to invite them to visit th office in the city to which they woul be assigned. During this visit yo have an added opportunity to do little promotional work, and yo should make the most of it. It goe without saying that any costs o expenses incurred by the applican should be reimbursed to them.

One phase of interviewing to which am sure little thought has been ven is to the interview follow-up which the recruiter endeavors to tain from his interviewees, or om persons in the Placement ireau if they are in a position to tain the information, the reactions these people to the way the re- iiter conducted the interviews. The formation obtained from these irces could be of invaluable assist- ce to you in helping polish your terview techniques. I have no ubt that a letter addressed to the erviewee on which he could either eck a predetermined answer or swers to a series of questions and urn without signature, or in which might feel free to write a little te, might prove to be not only most vealing but also most helpful in stering the recruiting process. Of irse, to get the real story any such mmunication should be unsigned. Suppose that your recruiting ef- ts have been successful, and that u have employed one or more pros- cts. At this point it would be sirable to write each prospect a ter outlining the terms and con- ions of employment, the compen- ion and, in general, covering any l all points which may have some ring upon the understanding of employment arrangement. The rpose of such a letter is obvious; prevents a misunderstanding at ne future time and this, of course, ld prevent the development of pleasant situations arising from h misunderstandings. The letter o serves to draw to a close the ruitment cycle.

neral Comments

Those of you who are recruiting he college level know full well the desirability of scheduling interviews well in advance of the close of the school year. It is not at all uncommon practice while at the school to set up the appointment date or dates for the ensuing year. You will find that the interview schedules are becoming increasingly crowded and, since the facilities available for interview are limited, such advance planning is necessary if you are to function most effectively as a recruiter. Also do not overlook the merit of what might be called pre-hiring interviews. Such interviews usually take place in the fall, that is, at the time when the June graduates are starting their final year in school. This serves as an excellent opportunity to establish contacts and permits of follow-up during the interim.

If you believe that the professional stature of your firm measures up to the requirements for participation in an internship program, let the school authorities know that you are interested in such participation, and, if at all possible, they will be happy to cooperate with you in assigning one or more students to you. While it may be argued that this infringes upon your otherwise productive time, do not lose sight of the fact that this is a valuable source of contact with possible future employees, and it permits you to have them on your payroll for a limited period of time without actually having established any obligation for employment. Not all students interested in this program are heading for employment with national firms, and it is my opinion that the smaller firms have been overlooking a good bet. One word of warning: do not apply for participation in this program unless you are doing a creditable professional job.

While you will note that many of the above comments relate to interviewing at colleges and universities, the techniques and methods outlined herein are equally applicable to the applicants who come to your attention from other sources, such as private employment agencies, responses to newspaper advertising, and through professional accounting organizations, such as National Association of Cost Accountants, state societies of certified public accountants, and the like.

You will note that I have made no reference herein to the use of the employment contract in connection with recruitment. While this device is sometimes used, its use is limited largely to personnel in the senior or supervisory category, and consequently because of its limited application and because of the fact that it is not universally used, it seems unnecessary to dwell upon it further.

Compensation

We now must face up to the problem which seems to be of considerable interest to both the employer and employee, the subject of compensation. The methods of compensation vary widely, ranging from a fixed salary, payable on a weekly, bi-weekly, semi-monthly, or monthly basis, to a fixed salary plus bonus based upon a production or profit schedule, plus a sundry assortment of fringe benefits, such as health, life and accident insurance, vacations graduated according to length of service, and in some cases even pension plans may be involved. Occasionally one will find that, in lieu of a salary or salary plus bonus, the compensation is merely a certain percentage of net profit. Still another form of compensation is based upon an hourl rate for time worked and is use generally in those situations whe the employee is on a temporary part time basis. It is not uncommo to pay a commission to staff perso nel for business brought to the firm

Amount of Compensation

There are several factors whi have a bearing in determining t amount and method of compensati employees. These may be summa ized as the nature and value of t services rendered to the employe the job classification of the employe the minimum and the maximu range within the particular j classification, the training, experien and length of service of the employe A further factor is the amount compensation which a firm must p in order to obtain the kind of st personnel it needs; another fact is sometimes referred to as what firm can afford to pay. The minimu compensation which a firm must p is that necessary to meet the co petition for its specific classificati of personnel within its own operati area, and if it will not pay that co pensation, it cannot secure compete staff personnel. On the other ha if a firm cannot pay that rate compensation, then it would se that it is not established on a sou operational basis and will find its working with sub-marginal personn which in turn generates many of t problems implied in the openi paragraph of this paper.

Call it by whatever name y choose, there is of necessity a fix relationship between fees charged professional services and compen tion of employees rendering th services. Indirectly this may be

y of evaluating what level of npensation can be paid to a par-ular staff member. For example, in your operation your rates are o times the staff compensation, a ff member generating $12,000 of ofessional income as a result of services might justify $6,000 by y of compensation. Or, as an ernative, the per diem billing rate a staff member may be one per-t of his annual compensation.

Rates of compensation, of course, l vary as between national firms, dium-sized firms, and small firms, l as between geographical areas. tes are also affected by the nature l type of the CPA's practice, but e fact is inescapable, every prac-oner is competing in the market ce for personnel, whether he be liated with a large, medium or all firm, and they in turn are in npetition with private industry l with national, state and local ernmental units. If the practition-expects to get the caliber of per-nel to meet his requirements, in st cases he will have to meet the ces established by normal working the law of supply and demand. mittedly there are some excep-ns to this general proposition; for mple, an employee may turn down opportunity in the City of Chi-o for an opportunity in Grand pids at a slightly lower rate of npensation because his living costs sumably may be less in Grand pids than in Chicago, and further-re, he may prefer to live in the aller community. But such con-ons essentially represent marginal ce fluctuations and are not too nificant dollar-wise in the final summation of the employment angement.

What really constitutes basic compensation? Basic compensation might be defined to include straight salary, plus bonuses, profit sharing, and overtime. All of these various elements in a very real sense are a direct payroll cost of an employee, and certainly must be reckoned with in comparing the compensation with revenue generated by that employee. Rates of compensation, as mentioned above, vary extensively as between schools, geographical areas, size of firms, public vs. private accounting, and also vs. governmental accounting. On one thing there is general agreement, that is, that the upward trend of the post-war years may be expected to continue as long as the demand for accounting talent exceeds the supply.

Overtime

The practice with respect to the payment of overtime varies widely within the profession. For those employees not subject to the Federal Wage and Hour Law, ovretime hours are paid for at straight time rates or at time-and-a-half. In other cases there is no specific payment for overtime but the amount of overtime is reckoned in evaluating the amount of the employee's bonus. Some firms follow the practice of offsetting overtime hours against slack time hours, thus providing the employee with additional time off over and above his usual vacation period. The Federal Wage and Hour Law provisions relating to payment of overtime apply to time worked in excess of a basic 40-hour week. Many firms, however, have a variable basic workweek, or rates of pay which require averaging or other adjustment to establish a workable and equitable method of paying overtime in compliance with

the statute. There are, of course, several approved methods for such averaging of time under the irregular workweek plan. These plans are known as the Belo-type, the time off, and the long workweek plans. For those interested, these various methods are covered in Chapter 7 of the *CPA Handbook*.

Bonus Plans

Bonus arrangements seem to be very widely used in the public accounting profession, although there appears to be no definite pattern to the various arrangements under which such bonus plans operate. Bonuses may be given as a reward for effective service, or in part for length of service and for the procurement of new business, or they may be used in lieu of a salary increase where the firm's financial stability is not sufficiently certain to warrant a guaranteed increase in compensation as represented by an increase in salary. Much has been written on the efficacy of bonus plans as a means of compensation, and as on most matters there seems to be a divergence of opinion. A bonus plan, if discretionary, of course works to the advantage of the employer and to the disadvantage of the employee in that there is no set commitment on the part of the employer to pay a bonus. A bonus plan once established, however, and no matter how discretionary, which does not result in some payment to the employee at the end of the bonus period in an amount at least equal to that received in the prior year can create dissatisfaction; in fact, any reduction in the amount would be considered a decrease in pay. This is indeed sometimes difficult to explain to an employee who perhaps that year had worked by f the largest number of hours of a year to date. Again, bonus plans this post-war economy have general been successful from the standpoi of compensating employees and fr the standpoint of overall employ morale because the tendency has be for a year-to-year increase. The p fession as a whole has yet to e perience the effects on staff mor in the event that bonuses had to curtailed or even eliminated becau of adverse circumstances. In su the adoption of any bonus pl should be given very careful co sideration by the firm's manageme Even in spite of the best possi planning, under certain circu stances, whatever arrangement w devised could create an exactly op site effect from that for which it w designed.

Profit-Sharing Plans

Profit-sharing plans within t profession may mean a current sp up of profits on some formula ba again with various limitations a restrictions, or the plan may provi for retirement benefits. Genera speaking, the latter form of pro sharing seems to have been adopt only to a limited extent, one rea being, perhaps, that the relat newness of the profession hasn't caused the problem to become o of significance. It is presumed, ho ever, that it will become increasin important in the years immediat ahead.

Fringe Benefits

No treatise on the subject of co pensation would be complete with some attention being paid to the called fringe benefits. In this resp

public accounting profession has
en keeping step with government
d private enterprise. The more
mmon forms of such fringe compen-
ion are paid vacations, paid sick
ve, paid health, accident and life
urance coverage, provision of sup-
money on those evenings involv-
overtime work. With respect to
cations there is a trend, again per-
os following the pattern of in-
stry, toward lengthening the pe-
d from the customary two weeks
er one year of service to an addi-
nal week after five or ten years
service, and even going to four
eks for those employees who have
n associated with the firm for some
nsiderable time. While the tend-
y seems to be in the direction of
unting longer vacation periods,
ause of the tight manpower con-
ion there also appears to be a
blem of scheduling vacations. We
the public accounting profession
ve either been too devoted to the
charge of our professional respon-
ilities and thus have relegated
ations to something to be taken
as, and when, or else we are too
hurious to provide the necessary
ff to permit the taking of vaca-
ns. It is generally conceded by
sonnel administrators and others
t vacations are an important mor-
builder and are essential to a
te of good health. All of us should
e a more realistic approach to
s important problem.

Not so many years ago the pay-
nt of a staff member during a
iod of absence for illness was the
eption rather than the rule, but
s conceded that the reverse situ-
n probably is true today. Plans
sick leave are varied from firm
firm, but the allowance of one day
nonth or two weeks per year is
not uncommon. Again, the applica-
tion of the sick leave may depend
to some extent upon the length of
service of the employee, his status in
the organization, his loyalty, his
record, and other such factors, but
by and large most public accounting
firms today make some provision for
continuing a staff member's pay
while he is absent from work on
account of illness.

Morale Boosters

The employers in the public ac-
counting profession have of recent
years given considerably more at-
tention to a category of activities
which I would term morale boosters.
Naturally practice in this respect
varies from firm to firm, but gener-
ally the underlying idea is to promote
the welfare of the organization as a
whole, and to create an esprit de
corps which inspires the members of
the organization to feel that they are
an integral and valuable part of it.
These activities are many and var-
ied, but by way of illustration,
they cover such things as staff
meetings, social meetings, (which
I would interpret to mean a dig-
nified label for a poker party),
annual parties at which not only
members of the staff but their wives
are also entertained, paid attendance
at professional meetings (attendance
at these may involve bringing along
the wife with the firm picking up
the tab), bowling team, annual golf
outings, provision of periodic medical
examinations, recognition of new
CPAs by a dinner meeting or some
other such activity, and parties given
in honor of departing staff members.
Most firms engage in some of these
activities to a greater or lesser degree,
but I foresee even greater attention
being given to the attendance of

staff members at various technical meetings. Many of these meetings are designed for the benefit of the wives as well as the husbands, and I venture to say that those firms which enable members of their staff to attend, accompanied by their wives, are well rewarded in terms of those intangibles which add up to a closely knit, well balanced and smoothly functioning organization.

Conclusion

In the interests of brevity, and there undoubtedly will be those who will charge that the term is used here rather loosely, I have purposely avoided exploring any particular phase of this subject in extensive detail. The recruiting and compensation of personnel are extremely important subjects, and many more pages could be devoted to exploring the various ramifications. While in individual situations it may not be practicable to adopt the program or techniques outlined here in their entirety, I cannot close without urging each of you again to direct some thought and effort in attempting to channel some of our high school graduates in the direction of accounting. We need to give this problem of the shortage of accountants our most urgent attention, because the accounting problems of our present day economy are not ours alone. The more trained personnel we are able through our efforts to divert into jobs in private industry, in government, and in our own professional practices, then to that extent will we have helped minimize some of the professional problems with which we have been struggling for several years.

Again quoting Mr. Miller Bailey: "Every permanent employee shou be engaged in the hope that he w continue with the firm for the r mainder of his life, with the thoug in mind that he is a potential partne and with serious intent to train hi for the most important position the firm, such training to contin until the employee has demonstrat the extent of his ability, whereup he can be fitted into his proper nich As leadership usually is inbor training cannot create it; . . . it necessary to seek it out throu training and to seek incessantly the end that no particle of talent f leadership escapes." That stateme succinctly points up the importan to the public accounting professi of those persons within it concern with the recruiting and compensati of staff personnel.

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DEVELOPMENT OF STAF PERSONNEL

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Introduction

As I see it "Development" is much broader in scope than mere Staff Training Programs which, while helpful, connote more of a technical education in procedures and theories within the firm. "Development" includes the responsibility for personality, dress and appearance, technical training, compensation, job classifications or titles, graduate education outside of the office, professional growth and understanding, etc. But even more important, "Development" to be successful also means keeping the staff personnel insofar as possible in your particular firm, or at least in the profession as a whole. Not many will dispute the fact that the profession has done a good job of developing its staff men, but has fallen down badly in providing the proper climate and incentives for retaining them within the profession. You need only look back on your own firm or that of your employer to realize the great number of excellent men who have been lost to industry. We who are crying the loudest for good men have allowed such men to drift away.

Here is a suggested outline for development of staff personnel as it applies to the new staff member a before he has reached the stage wh it becomes obvious that your fi wishes to KEEP him indefinite

Policies for Developing and Keeping Staff Personnel

First Three Months of Hire—

1. Indoctrination in rules, staff manual a office procedures
2. Small jobs with thorough review supervisors and partners
3. Constructive criticism of mistakes supervisors and partners
4. Permit time for assigned reading duties of junior accountant
5. Variety of assignments during in ductory period
6. Short staff meetings with regard office procedures and firm's audit review procedures
7. Conference with employee by partner supervisor as to what is expected of h some of firm policies and professio status of work

Three Months to Year—

1. Assignment to interim audit work w and without supervision
2. Responsibility for small field assignm or complete bookkeeping jobs
3. Staff meetings regarding tax audit other matters—
 a. Create awareness of problems invol even though not responsible for s
 b. Individual discussion of probl which the staff members have countered

. Discussion and encouragement of ideas presented by staff

Availability of direct contact with partners regarding personal and business matters—

. Periodic review with staff man as to his development
 (1) After completion of major assignments
 (2) After major changes in submitted report or field work and reason for same

. Personal matters—
 (1) Compensation
 (2) Personal evaluation of man by questionnaire circulated among supervisors or older staff
 (3) Expression of indvidual's development in partners eyes, including client relationship and personal appearance and personality development. If there is progress by the man, make him aware of it.

Year to Seven Years—

Advancement to jobs requiring increased esponsibilities—
. Larger clients
. More responsibiilty for client contacts
. Supervision of others
. Review of others' submitted reports
. Rotation of assignments

Encouragement of participation in activities outside the firm—
. Active association membership
 (1) Attendance at meetings
 (a) Both during and after workhours
 (b) Willingness of firm to share expenses
 (c) Encouragement of membership on committees without loss of money for time lost thereon
. Participation in civic and church groups
 (1) Reimbursement of expenses in certain situations
 (2) Willingness to allow time off if necessary
Participation in advanced courses and current accounting matters
 (1) Special courses sponsored by association
 (2) Advanced accounting courses or other specialized studies provided by universities to fill in missing background education
 (3) Through use of firm's library, including current bulletins and topics on taxes, systems, management, etc.

3. Other assignments—
 a. Brainstorm sessions for development of new ideas
 b. Assignments for review of current staff policies or procedures, and encouragement regarding improvements of same
 c. Periodic requests to staff men as to which assignments they wish to be transferred from and which assignments they wish to be assigned to

General—

1. Staff meetings for specific problems—Use all staff personnel to present talks or papers as an aid in their development
 a. Major changes in tax law
 b. Introduction to new fields—
 (1) Machine and system demonstrations by manufacturers
 (2) Invite outsiders to talk at specific meetings re: Their fields—
 (a) Insurance plans
 (b) Profit sharing and retirement plans
 (c) Business management or related fields

2. Professional status—
 a. Impress on employees their professioal status
 b. Treat employee as professional man and give him as much dignity and independence as possible
 c. Encourage writing of articles for professional magazines with prize awards by firm for accepted material
 d. Use of titles such as manager and principal below partnership level is important to feelings of staff about their status

3. Social activities—
 a. Office golf or Christmas parties
 b. Dinner dances for personnel and wives

4. Association with educators—
 a. Encourage continued contacts with faculties of their schools
 b. Invite accounting faculties to dinner meeting with firm and its employees

5. Grievances—
 a. Permit staff personnel to present grievances regarding firm policies by calling for suggestions periodically
6. Client relationship—
 a. Discuss with clients their reactions as to conduct of staff personnel while in their offices

How to Keep Your Staff Personnel

It is a matter of historical fact that accounting firms have kept only a fraction of the good men who have been in their employ. This is perhaps more true of the national firms than of the local firms. This has probably been a matter of business economics in that it has been (or may have seemed) impossible for firms to continue to pay higher salaries to some men unless they were of partnership stature, and consequently these men have gone into private businesses.

Consideration should be given to the creation of a staff status below the level of partners which will enable men who like public accounting, and I believe there are many, who would be willing to remain as non-partners within a salary range of say $7,500.00 to $15,000.00 per year. Or as an alternative, the firms should create special classes of partners below the level of general partners. Such partners may not be required to contribute any capital to the partnership.

It also appears that pension or retirement programs will eventually have to be created to provide for employees of a permanent nature.

Accounting firms can expect to retain staffmen only so long as they are given continued increases in compensation and provided with opportunities for professional growth and more challenging opportunities in job assignments. The best way provide this is through over- growth of the firm. The old max of "Grow or Die" surely applies accounting firms as it seems to oth business enterprises. This is t responsibility of the owners and pa ners. All local practitioners shou weigh carefully the advice of Jo Carey in his recent editorials in *T C.P.A. Magazine.* Mr. Carey sugge that sole proprietors might bet associate with others in partnershi to permit sharing of expenses, sp cialization and diversification a self improvement and (I might ad the opportunity to develop staff p sonnel in a larger combined practi

Certainly we cannot expect develop or keep professional men continuing routine assignments. we again get back to growth as essential ingredient to our proble We must provide growth in comp sation and growth in work opp tunity. If we must do some bo keeping, let the new staffmen do for a limited period or delegate su work to a special class of women men bookkeepers within your orga zation who are not considered p of your professional group.

If we can't always grow in volu of work, we can still grow in qual of work. Through continual edu tion of our clients to assume bookkeeping functions we will f ourselves and staff for professio work.

To keep your staff under sta conditions you must be large enou to provide opportunities through tirement of partners or other personnel. This is a condition likely to be found in such a you profession particularly in the lo firms. So my advice is to merge w

ith other small firms, purchase counting practices of those ready retire or taken by death, colonize a suburban area with a branch fice, be more selective in the type work you do, take up management nsulting activities on a formal sis instead of an informal basis, ut GROW and provide opportuni-es for your staff to develop with ou.

ome Advice to Sole Proprietors and Partners

We must compensate our staff equately and fairly; we should be generous as possible in paying inge benefits and costs incident to tside activities relating to staff development. We should also be generous in the matter of length of vacations and time-off for outside activities. We should create an atmosphere of cooperation among all personnel and permit the development of dignity and independence for all. We must conduct ourselves in a manner and establish policies that will make each person happy to be part of the organization.

The greatest possible contribution that can be made by the partners and owners is to make themselves available to the staff and not sit in an "ivory tower." The wisdom they possess should be passed on to the staff as rapidly and as often as possible.

TESTING THE RELIABILITY OF AUDIT EVIDENCE

FLOYD W. WINDAL

In order to render an opinion on the fairness of the financial statements of an enterprise, the independent certified public accountant makes an examination of the accounting records of that enterprise and takes any other auditing steps he deems necessary in the circumstances. His primary aim is to obtain sufficient evidence from his examination to satisfy himself as to the fairness of the statements. In addition, the evidence must be sufficient to justify and support the conclusion he reaches.

It may well be asked at this point—what is the nature of this evidential matter which the auditor obtains? One author [1] defines evidence in auditing as any document, procedure, or piece of information which assists the auditor in forming his professional opinion as to the accuracy of the financial information he examines. He further lists the following types of evidence which the auditor may obtain:

1. Physical existence of the thing represented by the accounts.
2. Authoritative documents.
3. Oral or written statements by independent third parties.
4. Calculations by the auditor.
5. Satisfactory internal control.
6. Complete subsidiary or detail record in good order.
7. Subsequent actions of the company under examination.
8. Formal statements by company's officers or employees.
9. Informal statements by the company officers or employees.

From this list it can be seen that some types of evidence are more convincing than others, and therefore more acceptable to the auditor. For instance, in verifying the fixed asset account for Delivery Equipment, the auditor may physically examine the delivery truck. In doing so he has obtained some very convincing evidence. Although he will undoubtedly obtain further evidence concerning the ownership of the truck and concerning the monetary amount at which it is carried, he is at least certain that such a truck exists. Now look to the verification of the balance of the Accounts Receivable account. The auditor may examine the subsidiary accounts receivable ledger and determine that its total agrees with the controlling account balance in the general ledger. Although some evidence is provided thereby, it is not completely satisfactory. The subsidiary record is entirely under the control of the enterprise being audited, and it is possible that some

[1] R. K. Mautz, *Fundamentals of Auditing* (New York: John Wiley and Sons, Inc., 1954), p. 33.

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ems are entered incorrectly, or that ıe entire record is a false one pre- ared especially to influence the ıditor. Little evidence is provided ; to the validity and collectability the accounts.

These illustrations point up the eed for the auditor to evaluate each pe of evidence he obtains. If one pe does not satisfy him as to the rrectness of an item examined, he ust extend his examination to ob- in other types. In many situations, e may find it necessary to ob- in several different types of evi- ence before he feels he has satis- ctorily verified a particular item.

UDITING TECHNIQUES AND PROCEDURES

In order to obtain this competent ridential matter the auditor em- oys various auditing techniques uring the course of his examination. . C. Littleton defines these tech- ques as means of putting the ıditor's mind into contact with the ient's records, and ways of testing hat is against what should be.[2] other words, they are devices or ethods available to the auditor for taining evidence. For instance, rough the technique of "physical amination and/or count" evidence obtained of the physical existence the thing represented in the count. The technique of "inquiry" used to obtain *formal or informal* atements by the company's officers employees. Thus, each type of idence may be traced to one or ore techniques which were used to tain it.

Through the use of these tech- ques, jointly or separately, the ditor is able to acquire a body of evidence upon which he can base his opinion. The manner in which these techniques are employed by the auditor in a particular phase of the audit may be referred to as an audit procedure. Thus, in a particular audit engagement, the auditor will utilize the various auditing techniques in establishing audit procedures. When applied, these will provide the competent evidential matter required by generally accepted auditing standards.

THE MEANING OF RELIABILITY

It is apparent that some types of evidence form a better basis for an auditor's judgment than other types. Whereas he will put little reliance on some types of evidence, he will accept other types almost without question. For example, he would be willing to accept a statement by an independent trustee as to the existence of a sinking fund, whereas a similar statement by an officer of the firm being audited would carry little weight. Further, he would put more reliance on the fact that he has seen a particular fixed asset than on the fact that he has examined the purchase invoice for it. Examples such as these are numerous, and point up the need for the auditor to fully understand the nature of the various types of evidence with which he deals. He should be conscious of *why* he accepts one type of evidence and rejects another; of *why* he regards one type of evidence as more reliable than another.

As used here, the term "reliable" is not meant to imply reliability as legal evidence. Although it is recognized that the auditor must be able to support his conclusions in a court of law, if necessary, the emphasis here is not in that direction. Rather,

[2] A. C. Littleton, "Auditing Principles," *The urnal of Accountancy* (August, 1942), p. 108.

attention is directed at satisfying the auditor himself. Which types of evidence should he be most willing to accept in the mental process of deciding on the fairness of financial statements? The question might be asked of each type of evidence: To what extent should the auditor rely upon this as a basis for his opinion, realizing that he is basing his professional reputation on such reliance?

Another point worthy of consideration is that the *quantity* of a particular type of evidence has no bearing on its reliability, as that term is used here. The emphasis is rather on the *quality* of each type of evidence.

Tests of Reliability

It can thus be seen that the independent certified public accountant is constantly evaluating the various types of audit evidence during the course of his audit. Some types of evidence he accepts readily as a basis for rendering his opinion. Other types he is willing to accept only with qualification. Although he may not realize that he is doing it, throughout this evaluation process the auditor is applying certain tests of reliability to the evidence. By consciously or unconsciously applying these tests to the evidence he obtains, he is able to decide in his own mind which techniques are most reliable.

In an attempt to spell out for future analysis and evaluation these somewhat nebulous concepts in the mind of the auditor, some standards of reliability have been formulated which may be used as tests. Three of these tests are generally applicable and can be applied to all of the audit techniques to test their reliability. These three, along with a discussion of each, are:

1. Evidence which is obtained from a source independent of the enterprise being audited tends to be more reliable than evidence obtained from a source within that enterprise.

The reason for examining the financial statements of a particular firm is to determine if that firm is fairly presenting its financial position and the results of its operations. It is obvious, then, that information obtained from that firm is of limited value. If a banker wishes to find out if a particular person is a good credit risk, he does not rely heavily on the statements of that person. Rather, he seeks information elsewhere.

The case of the auditor is similar. He must, of course, start his examination with the accounting records of the firm being audited and with the transactions entered therein. This is not the final step, however. The variety of business documents supporting these transactions will be examined, many of which originate with an outside source. The latter will be given greater weight by the auditor because they serve to verify what the firm itself asserts to be true. The auditor would also communicate directly with outsiders, not only to verify information already contained in the accounting records but to obtain additional information as well.

It should not be inferred from the preceding discussion that information obtained from an outside source is *always* more reliable than information obtained internally. As with most generalizations, exceptions can be found. Some outside sources would be very unreliable, either due to lack of accurate bookkeeping or to a lack of desire to give the information requested. Some private

ividuals, for example, would have idea of the exact amount they owe a particular company on a par- ılar date. In a company with a d system of internal control, refore, the auditor would get more able evidence as to their debt by erring to the accounts receivable ord.

Evidence which is objective in nature tends to be more reliable than evidence which reflects personal judgment or bias.

f a particular garment is either ck or white, anyone who examines vill arrive at the same conclusion to its color. If, however, it is an ısual offshade, persons examining nay call it any one of a variety of ors. In the first case, the evidence o the color of the garment is very ective; any one of the persons mining it will arrive at the same wer. In the second case, the evi- ce is quite subjective; the persons mining it will very likely come different conclusions. It is appar- that the evidence provided in first case is the more reliable.

'his illustration is indicative of evidence available in auditing. ne of it is very objective, some y subjective, and some in between. is up to the auditor to examine ı piece of evidence carefully and e it the weight it deserves. To strate the application of this test, t first at the evidence provided extending the prices on an entory sheet—multiplying the ntity on hand times the unit e. The total obtained from such mputation, if made correctly, is uestionable. Any one of a hun- d persons could make the com- ation and they would arrive at same answer. It is difficult to conceive of evidence more objective than this. Scanning a large number of cancelled checks for correct signatures and endorsements, however, would provide evidence of a different nature. An auditor examining the checks may or may not notice a forged signature, or a questionable endorsement, depending upon his alertness and ability. Thus, the evidence obtained is to a large extent, subjective and less reliable.

3. Evidence obtained by the auditor himself or by his representative tends to be more reliable than evidence supplied by another, except where the auditor is not qualified to obtain that evidence.

It is easy to see why an auditor might be skeptical about evidence obtained second-hand. He must, in that case, be concerned about the integrity of the person involved, with his independence from the firm being audited, and with the source of his information. For example, a lawyer who is dishonest could give the auditor misleading information concerning contingent liabilities. A person who claimed to be a debtor of the firm might actually be an affiliate testifying falsely. An actual debtor might have insufficient records to report the exact amount of his debt. All of these possibilities help to make second-hand information less reliable than that obtained by the auditor himself.

In addition to these general tests, a group of special tests may be utilized to determine the reliability of various types of evidence. These tests are more limited in nature and cannot be applied to all of the techniques. However, they can be applied effectively to specific techniques to test their reliability in specific situations. These tests are:

1. Evidence based upon internal data which have been derived from an accounting system containing adequate internal control tends to be more reliable than evidence based upon data derived from a system without such control.

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.[3] From this definition it can be seen that internal control is a very broad term, and is not solely concerned with the accounting records of the enterprise. However, all of the elements of a good system of internal control tend toward making those records accurate and reliable. A clear cut organizational plan, for instance, with organizational independence of departments and definite lines of responsibility provides an effective check on the performance of the personnel of those departments, and thus on the records they prepare. Such sound practices as the division of duties provide an automatic check on the accuracy of work and the probability of errors or fraud being detected promptly is substantially enhanced. An adequate system of authorization and record procedures is, of course, directly concerned with the accounting records and helps make them more reliable.

The auditor is not sure, when he begins the audit of a particular firm, whether or not its system of internal control is adequate. He will, of course, have made a study of th plan of organization and of th procedures of the firm. However, h will not be sure that the procedur prescribed are actually followed an that the plan of organization specifi is actually in effect. These thing he will have to determine in th course of his audit.

It is important, then, that th auditor take this matter of intern control into consideration when e amining internal data. If these da are derived within a poor system internal control, their validity as basis for reliable evidence shou certainly be questioned.

2. Evidence obtained from outside sourc which maintain formal account records and/or have a sense of pub or personal responsibility tends to more reliable than evidence obtain from an outside source with ina quate records and/or little or no sen of public or personal responsibili

As indicated in the discussion general test No. 1, the evidence o tained from some outside sources unreliable. For instance, an outsi source which does not maintain a adequate set of records quite possib does not have readily available t information desired. An answer gi en to a request might in that ca be predicated entirely on memory, on a guess. Obviously, such eviden is not very reliable.

Some outside sources have a sen of public responsibility which wou influence them to give correct an reliable information. A lawyer, f example, is a professional man, w holds himself out to the gener public as an independent expert be trusted and confided in. It wou be to his advantage, then, to avo any conduct which would reflect his integrity and independence.

[3]American Institute of Certified Public Accountants, *Internal Control*. Prepared by the Committee on Auditing Procedure (New York: American Institute of Certified Public Accountants, 1949), p. 6.

The knowledge that a particular tside source has a sense of per- ıal responsibility would also con- bute to the reliability of the in- rmation furnished. Those persons o feel no inner desire to be honest, d who have no regard for other ople, would certainly be an un- iable source of information.

. The examination of items which are relatively more susceptible to fraud tends to give less reliable evidence than the examination of items less susceptible to fraud.

Because of their nature, some items more susceptible to fraud than ıer items. For example, an item ich is very valuable is more likely be the object of fraud than an n that is worth very little. Also, ud is more difficult to detect if it cerns an item which would require appraisal of an expert in order determine its value than if it con- ns an item which has a readily cernible value. Thus, evidence ob- ıed from examining some precious ıs would be less reliable than dence obtained from examining a nmower.

This test can also be applied to ginal documents examined. Those uments which are relatively easy reproduce are more likely to be udulent than those documents ch are difficult to reproduce. For mple, a purchase invoice is more ly to be fraudulent than a can- ed check.

Because of the wide variety of ıs which the auditor examines in course of an audit, many other mples such as these may be found. hough an auditor may not realize is doing so, he accepts or rejects ıy items as reliable evidence on basis of this test.

4. In those special situations where the auditor is not qualified to apply a particular technique, the evidence obtained from such application is relatively unreliable.

Normally, information obtained first-hand by the auditor is more reliable than information obtained second-hand. It is obvious, however, that in those cases where the auditor is not qualified to obtain that evidence, it will not prove very reliable. A notable illustration of this in in the case of inventories. An auditor, who normally deals with a large variety of enterprises, cannot possibly be an expert on every type of inventory. It is not likely, for instance, that he will be able to distinguish every type of mineral ore; nor will he be able to distinguish every type and grade of grain. Some fixed assets, as well, may be unfamiliar to him. For example, he probably will not be able to recognize every type of machinery.

As another example, some auditors would not be qualified to utilize the technique of scanning. An inexperienced junior, for example, would not obtain reliable evidence through its use.

5. Confirmations which can be handled without effort by the party confirming tend to be less reliable than confirmation which require effort.

This test applies specifically to the various types of confirmations which may be utilized. The negative confirmation, which requires no effort by the party confirming, is the least reliable. Because the party confirming is asked to return the confirmation only if the information contained thereon is incorrect, the auditor has no way of knowing whether a confirmation not returned was actually checked and found to be

correct. The positive confirmation, then, which must be returned whether or not the information contained thereon is correct, is more reliable than the negative confirmation. Finally, the "blind" request, where the party confirming must actually write in the information desired, provides the most reliable evidence. The one filling it in does not know what the records of the firm being audited show, and must therefore get th information from his own efforts.

The tests presented here are n intended to be exhaustive. Othe possibly can be devised and appli to the various types of auditi evidence. However, it is felt th those presented are sufficient f illustrating the nature of the te visualized, and for stimulating fu ther thought in their direction.

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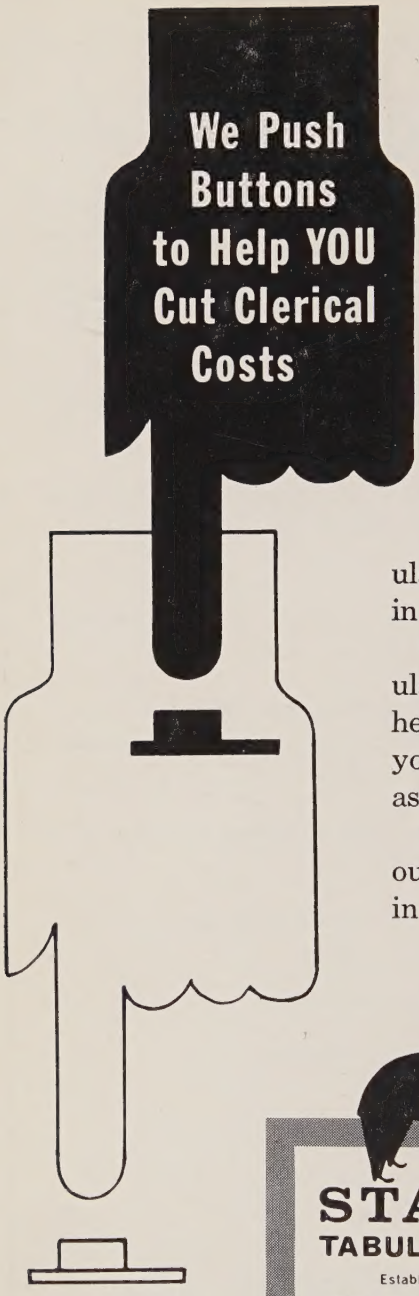
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